Orange County

Treasurer's Investment Strategy Was Excessively Risky and Violated the Public Trust

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Summary

Audit Highlights ...

The treasurer:

☑ *Violated the basic principles of prudent investing.*

... inverse floaters and other structured securities.

The Orange County (county) treasurer is responsible for receiving and keeping safe all funds belonging to the county and other monies deposited with the treasurer. However, we found that the former treasurer pursued an investment strategy that violated the basic principles of prudent investing, which are safety, liquidity, and yield, in that order. In fact, his investment strategies were diametrically opposed to these principles. The former treasurer's investments were unsafe, highly risky, and extremely volatile, and they lacked the liquidity needed to meet the portfolio's objectives. Further, he sacrificed safety and liquidity in a failed strategy to capture higher yields. The former treasurer did this by leveraging the portfolio more than 2.7 times and purchasing highly volatile inverse floaters and other structured securities that comprised more than 40 percent of his investments.

According to our investment consultants, the former treasurer's investment practices were inappropriate for the county's short-term investment pool and exposed the pool participants to unnecessary risks. As a result of the former treasurer's imprudent and reckless investment strategies, the county and other participants in the treasurer's portfolio incurred losses of $1.69 billion, which caused the county's bankruptcy. Ultimately, these losses will have far-reaching effects, including the loss of jobs and the reduction of critical local government services.

Furthermore, we found the following:

- The former treasurer violated his trust responsibilities to participants in the investment pool. When the county and other public entities deposit their funds into the county treasury, a trust relationship is established between the treasurer and these entities;

- The treasurer's office altered county accounting records for investment pool interest earnings. As a result, the county's general fund received approximately $93 million more interest earnings than it was entitled to receive from the investment portfolio;

- The treasurer's office inappropriately transferred securities from the county's specific investment account. At the time of the transfers, the county's securities had accumulated a $271 million loss that was shared by all pool participants;

- Eight of the 14 brokerage firms that we surveyed reported that they had revenues of at least $21.3 million in 1994 and $46.3 million in 1993 from financial transactions with the county. The remaining 6 did not provide compensation information. Further, we believe that most of the firms did not disclose all their compensation earned on investment transactions with the county; and

- The county estimated that approximately $23.7 million will be spent for bankruptcy-related costs through June 30, 1995. The county retained ten firms to provide various services, including legal services for the bankruptcy, litigation services, and advisory services.

Recommendations

To improve the operations of the Orange County treasurer's office, we recommend that the board of supervisors direct the treasurer's office to prepare a comprehensive investment policy. In part, the policy should do the following:

- Establish guidelines to achieve safety, liquidity, and yield while diversifying the portfolio, preserving capital, and maintaining cash flow;

- Limit the use of reverse repurchase agreements and ensure that they are in accordance with existing statutes and restrict the purchase of derivatives and other structured instruments;

- Specify authority and accountability over investment practices by defining prudence and detailing fiduciary responsibilities for the treasurer;

- Require a competitive bidding process for brokers and dealers;

- Create an investment advisory committee independent of the treasurer's office; and

- Require the treasurer to report, at least quarterly, on the investment activities and holdings to the board of supervisors, the advisory committee, and pool participants.

In addition, we recommend that the board of supervisors establish strict rules regarding ethics, conflict of interest, and asset safekeeping for all the county's investment activities, and adopt and approve the treasurer's comprehensive investment policies. Furthermore, the board should rectify the inequities caused by inappropriate interest allocations and the transfer of the county's losses to other pool participants and ensure that future allocations of interest earnings are accurate. Finally, the board should restore the $73 million to the Teeter Plan taxable note repayment fund that was inappropriately transferred to the county's general fund.

To improve the investment practices of local governments, we recommend that the Legislature amend the California Government Code. A few of our key recommendations are to:

- Require written investment policies for all local governing bodies to ensure that safety and liquidity are paramount to yield;
- Limit the use of reverse repurchase agreements to 20 percent of the portfolio and only for specified purposes, and restrict the purchase of derivatives or other structured instruments;
- Establish and define a prudent person rule for local investment officers;
- Require investment reports, at least quarterly, to the governing body and investment participants; and
- Prohibit the issuance of taxable or nontaxable debt for speculation or risk arbitrage investment purposes.

Agency Comments

In its response, the county states that it generally concurs with the findings and recommendations and discusses the actions that have already been taken to address the deficiencies. However, the county's auditor-controller disagrees with the appendix to the report concerning the transfer of restricted funds. The county states that its staff is researching this and will advise us of the outcome later.

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Introduction

With more than 2.5 million residents, Orange County (county) is the third most populated county in California. The county provides a wide range of services to its residents, including education, law enforcement, fire protection, medical and health programs, senior citizen assistance programs, and a variety of public assistance programs. The county budget was approximately $2.185 billion for fiscal year 1993-94. In December 1994, the county filed for bankruptcy protection when its investments experienced significant losses.

The county is governed by a five-member board of supervisors with each supervisor serving a four-year term. The board is elected by the citizens of the county. The citizens also elect the county treasurer-tax collector (treasurer), who serves a four-year term.

Orange County Treasurer's Office

According to the California Government Code, Section 27000, the county treasurer is responsible for receiving and keeping safe all monies belonging to the county and all other monies directed by law to be paid to the treasurer. In addition to managing county monies, such as property taxes, the county treasurer manages the monies of approximately 190 public agencies, including cities, special districts, and school districts. Although some of these agencies are outside of Orange County boundaries, the vast majority are located within the county.

State law generally requires that all monies of the county and the school districts be held by the county treasurer. Other public agencies, such as cities and special districts, voluntarily deposit their monies into the county's treasury. The California Government Code, Section 53684, permits these local agencies to deposit excess funds into the county treasury if authorized by the agency's governing board and if the deposit is accepted by the treasurer.

The county combines its funds and other public agencies' funds in a commingled investment pool, a commingled bond investment pool, and specific investment accounts. This pooling arrangement allows governmental agencies to combine money for investment purposes. The use of investment pools allows for the purchase of large denominations of securities, which usually provide higher yields than those available to smaller investors. On November 30, 1994, shortly before the bankruptcy filing, the treasurer's investment portfolio was $20.6 billion. The portfolio consisted of $16.9 billion in the commingled investment pool, $2.3 billion in the commingled bond investment pool, and $1.4 billion in specific investments.

The amount of total investments in the portfolio increased significantly from 1991 through 1994. The total investments increased by $15.8 billion, or 310 percent, from January 31, 1991, through January 31, 1994. Table 1 presents the total investments from January 31, 1991, through January 31, 1994.

Table 1

Amount of Total Investments in the Orange County Treasurer's Portfolio January 31, 1991, Through January 31, 1994

Date	Amount Invested
January 31, 1991	$ 5.1 billion
January 31, 1992	6.9 billion
January 31, 1993	10.5 billion
January 31, 1994	20.9 billion

Source: Monthly investment reports of the county treasurer's office.

One reason for the increase in the amount invested as shown in Table 1 is the issuance of taxable debt for investment in the county's portfolio. In 1994, the county issued taxable debt of $600 million and 12 other members issued taxable debt totaling $562.2 million and invested these debt proceeds into the former treasurer's portfolio. However, because of the substantial portfolio loss and the subsequent bankruptcy filing, the county and the 12 members not only lost some of their initial investment, but also must now determine how the debt on these notes will be paid at maturity. Table 2 shows the amount of taxable debt that the county and the 12 members incurred in 1994 for investment purposes.

Table 2

Taxable Debt Issued for Investment in County Treasury Calendar Year 1994 (in thousands)

Name	Amount of Debt

County of Orange	$ 600,000
Orange County Flood Control District	100,000
City of Anaheim	95,000
City of Irvine	62,455
North Orange County Community College District	56,285
Irvine Unified School District	54,575
Placentia-Yorba Linda Unified School District	50,000
Newport Mesa Unified School District	46,960
Orange County Board of Education	42,180
City of Montebello	25,000
City of Santa Barbara	14,700
City of Placentia	10,000
Garden Grove Sanitation District	5,075
Total	**$1,162,230**

Source: Responses to the Bureau of State Audits' inquiries.

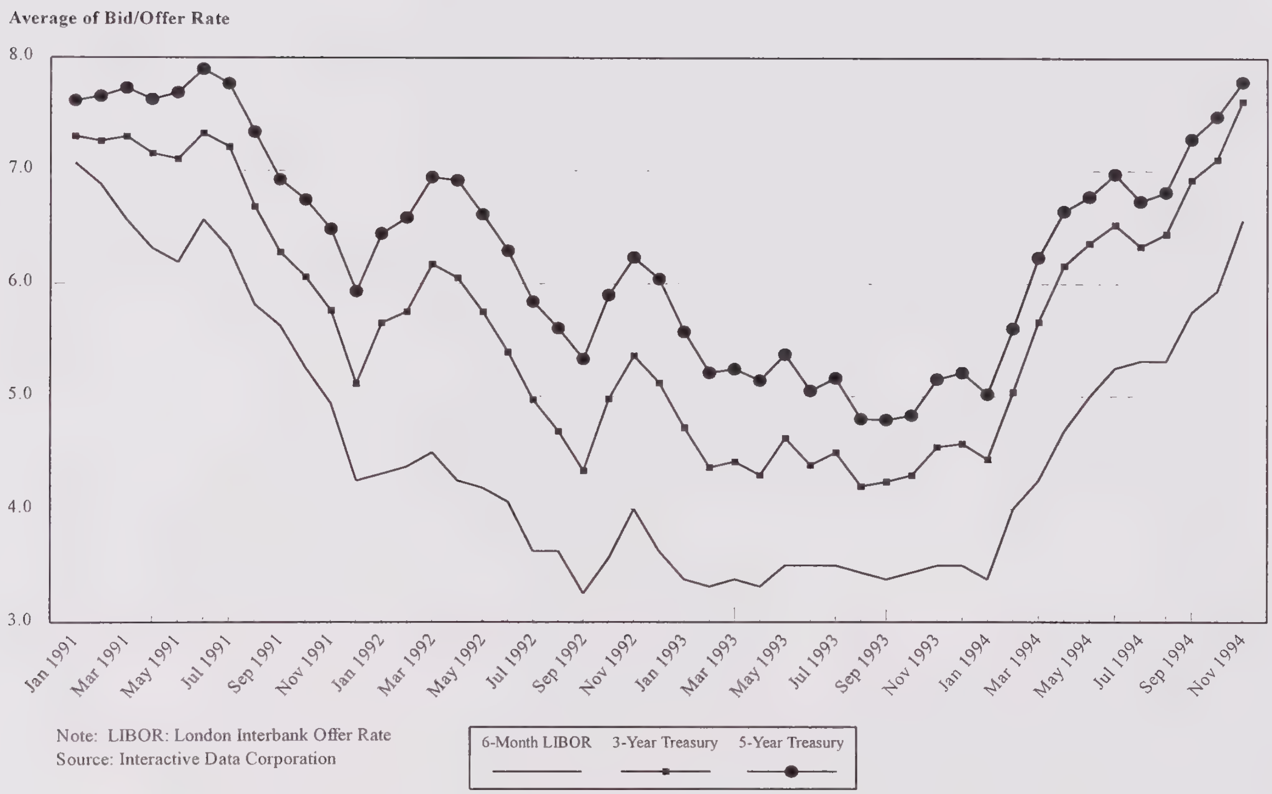
Filing for Bankruptcy Protection

The former treasurer's investment portfolio was highly leveraged and extremely sensitive to interest rate increases. As illustrated in Figure 1, interest rates began rising sharply in early 1994. This caused the portfolio to lose significant value.

On December 1, 1994, the county announced that its portfolio incurred paper losses totaling an estimated $1.5 billion. A paper loss is the difference between the cost of the investment and its market value, but it is not realized until the investment is sold. Three days later, on December 4, 1994, the treasurer resigned his elected position.

Figure 1

Interest Rate Changes
January 1991 Through November 1994



Note: LIBOR: London Interbank Offer Rate
Source: Interactive Data Corporation

On December 6, 1994, the board of supervisors filed for bankruptcy protection under Chapter 9 of federal bankruptcy laws. The board filed bankruptcy on behalf of the county and the pool participants so that their financial problems could be resolved in an orderly fashion and claims could be restructured without any disruption in the operations of the county or other participants in the investment pools. In addition, the board of supervisors filed for bankruptcy protection because investment bankers declined to renegotiate or renew existing reverse repurchase agreements.

To assist the county with its bankruptcy filing and its financial management, the board of supervisors appointed a director of financial restructuring. Also, in December 1994, the board appointed an interim treasurer. Further, the board appointed an investment banking firm to advise the county on its investments. Initially, in December 1994, the loss to the portfolio was estimated at

$2.02 billion. However, in January 1995, the loss was revised to $1.69 billion, an improvement of $330 million. On March 17, 1995, the board of supervisors appointed a new treasurer.

Pending Investigations

The county district attorney is conducting a criminal investigation into possible wrongdoing at the treasurer's office. As part of the investigation, the district attorney seized nearly all the records from the treasurer's office.

In late January 1995, the county announced that accounting irregularities were found at the treasurer's office. As a result, the acting treasurer placed all 17 employees of the treasurer's office on paid administrative leave. Since that time, the treasurer's office has approved the return of certain employees. The county is investigating the accounting irregularities.

In addition to the investigations by the district attorney and the county, the U.S. Securities and Exchange Commission (commission) is conducting an investigation of the portfolio managed by the treasurer's office. Specifically, the commission is determining whether there have been any violations of federal securities laws.

Scope and Methodology

The Bureau of State Audits was requested by the governor and the California Legislature to conduct an audit of selected activities of the county. This is our third report on the county. The first two audit reports dealt with the estimated amount of the losses from investment activities of the treasurer's office and with the county's cash flow projection. In the second report, we stated that we would obtain a legal opinion on the propriety of transferring funds from the Teeter Plan taxable note repayment fund to the county's general fund. As discussed in the appendix, based on our legal counsel's review, we have concluded that the transfers of funds were inappropriate.

During this audit, we reviewed the following:

- The investment strategy of the former treasurer, the degree of risk in the portfolio, and an analysis of the former treasurer's investments;

- The former treasurer's trust responsibilities to act for the benefit of the county and other pool participants, including allocating interest income, transferring securities among participants, and treating all participants in a consistent manner; and

- Fees and expenses related to short- and long-term debt issues, investment activities, bankruptcy and related financial management, and legal representation for current and former employees.

To assist us in evaluating the former treasurer's investment strategy, we engaged the services of an investment consulting firm—Analysis Group, Inc. These investment experts performed a review of the former treasurer's

investment strategy since January 1991, including the degree of investment risk in the portfolio, and an analysis of the former treasurer's investments.

To evaluate the trust responsibility of the former treasurer, we obtained a legal opinion on the treasurer's duties when investing funds on behalf of the portfolio's participants. Also, we reviewed the available records to determine if the treasurer's office used appropriate methods to allocate interest earnings to participants. In addition, we reviewed records to determine the propriety of fund transfers from the unapportioned interest fund to the commingled investment pool reserve fund. Further, we reviewed the transfer of securities from a county account to the commingled investment pool. Moreover, we mailed questionnaires to participants in the investment portfolio to obtain an understanding of the relationship between the treasurer's office and the participants.

To determine the fees paid to underwriters, bond counsels, and financial advisors, we reviewed the 1993 and 1994 short- and long-term debt issued by the treasurer's office and the county administrative office. We also requested that investment brokerage firms provide us with the amount of compensation earned from investment activities with the county. Finally, we obtained from the county the estimated costs related to the bankruptcy filing for various services, including legal services, litigation services, and financial advisory services. We limited our review of debt issues to those that had underwriters, bond counsels, and financial advisors that the board of supervisors or the treasurer's office selected.

Our review of the operations of the treasurer's office was limited because employees of the office were placed on administrative leave during our fieldwork. As a result, we were unable to interview knowledgeable staff on operations of the treasurer's office and could not obtain documents kept by these employees. Another factor that limited our review was the seizure of the treasurer's office records by the county district attorney. The records seized filled approximately 200 boxes. Although the district attorney permitted us access to these records, locating pertinent records was extremely difficult because of the large volume of documents. Consequently, we may not have reviewed all the relevant documents.

Chapter 1

The Treasurer's Imprudent Investment Practices Were Excessively Risky

Chapter Summary

The former treasurer of Orange County pursued an investment strategy that violated the basic tenets of prudent investing practices: it was highly risky, it was extremely volatile, and it lacked liquidity. This strategy involved leveraging or borrowing billions of dollars against the portfolio to obtain cash for investments. These borrowed billions in cash were then used to purchase securities, known as derivatives, that were highly sensitive to changes in interest rates.

When interest rates rose during 1994, many of the derivatives purchased—those called inverse floaters, whose value drops when interest rates rise—fell precipitously. By November 30, 1994, shortly before Orange County's (county) bankruptcy, the former treasurer had leveraged the investment pool more than 2.7 times and had more than 40 percent of his investments in highly volatile inverse floaters and other structured securities sensitive to interest rate fluctuations.

According to the investment experts we contracted with, the former treasurer's investment policies were inappropriate for a short-term local government investment pool and exposed the pool participants to unnecessary risks. The former treasurer's imprudent and reckless investment practices ultimately led to a $1.69 billion loss to the county and 190 other public agencies and caused widespread repercussions, including the loss of jobs, potential reduction of critical local government services, and possible cuts in education funding.

Basic Principles of Prudent Investment Practices

When funds are invested on behalf of public entities, the fundamental principles are safety, liquidity, and yield, in that order. Safety, the preservation of investment capital, is the foremost objective. To ensure the preservation of capital, the investor should restrict the investments to high-quality, low-risk securities purchased from reputable dealers. Liquidity, the second priority, is the ability to readily convert investments to cash to meet the spending needs of the participants. To ensure liquidity, investments should be limited to short-term securities that are actively traded in a secondary market. A secondary market is one in which there are sufficient buyers and sellers, so that a particular asset can be readily converted to cash. Yield, the return on investments, is the third priority. It should not become a consideration until the basic requirements of safety and liquidity have been met.

Investment strategy actually followed by treasurer was the exact opposite of his stated policies.

The former treasurer's Statement of Investment Policy purports to meet these objectives by stating that preservation of investment capital is the primary concern and that the achievement of a high yield must be considered secondary to the safety and liquidity of the investment portfolio. The policy also specifically states that no unreasonable risks would be taken. However, the investment strategy actually followed by the former treasurer appears to be the exact opposite of his stated policy, wherein yield became paramount over safety and liquidity. In fact, the former treasurer testified before a senate special committee that maximizing yield became the driving force behind his investment actions.

Maximizing yield became the driving force behind his investment actions.

According to our investment experts who analyzed the former treasurer's investment activities, the portfolio reflected a high degree of risk because of two strategies used to increase investment yield. First, the investments were heavily leveraged (or borrowed against) through the use of reverse repurchase agreements (reverse repos). Second, the former treasurer invested in many longer term and higher risk securities that would be profitable only if interest rates did not rise.

The Treasurer Excessively Leveraged the Portfolio

The former treasurer significantly leveraged his portfolio through the use of reverse repos. In a reverse repo, the owner of a security, such as the county, "borrows" by selling the security to an investment broker with an agreement to repurchase it a short time later. In effect, the security held by the broker is collateral for a loan transaction. In a reverse repo transaction, the security owner agrees to pay a stipulated rate of interest to the broker as the cost of borrowing the money. The security owner receives short-term cash from the broker, without permanently relinquishing ownership of the underlying security. The security owner can then invest the cash received, leveraging the original principal by, in effect, investing the same money twice. If the cost of the borrowing is less than the earnings on the investment, the reverse repo transaction is beneficial to the security owner.

Treasurer's reverse repo strategy was not limited to borrowing only once on a security, but instead incurred multiple levels of borrowing on a single security. "...We have perfected the reverse repo procedure to a new level."

The former treasurer used reverse repos as the primary means to increase the yield on the portfolio. In pursuing his reverse repo strategy, he did not limit himself to borrowing only once on a security, but instead incurred multiple levels of borrowing on a single security. He explained his reverse repo strategy in his annual report to the board of supervisors, dated August 28, 1991. He explained that he purchased one security and borrowed against it using a reverse repo to purchase another security that he would use as collateral to borrow again. In his example, he borrowed three different times using the original investment. In describing his strategy, the former treasurer commented that "we have perfected the reverse repo procedure to a new level."

Figure 2 illustrates the multiple levels of borrowing, or leveraging, used by the county. Although we have created the specific details in the example for ease in presentation, the example is representative of the leveraging that the former treasurer used.

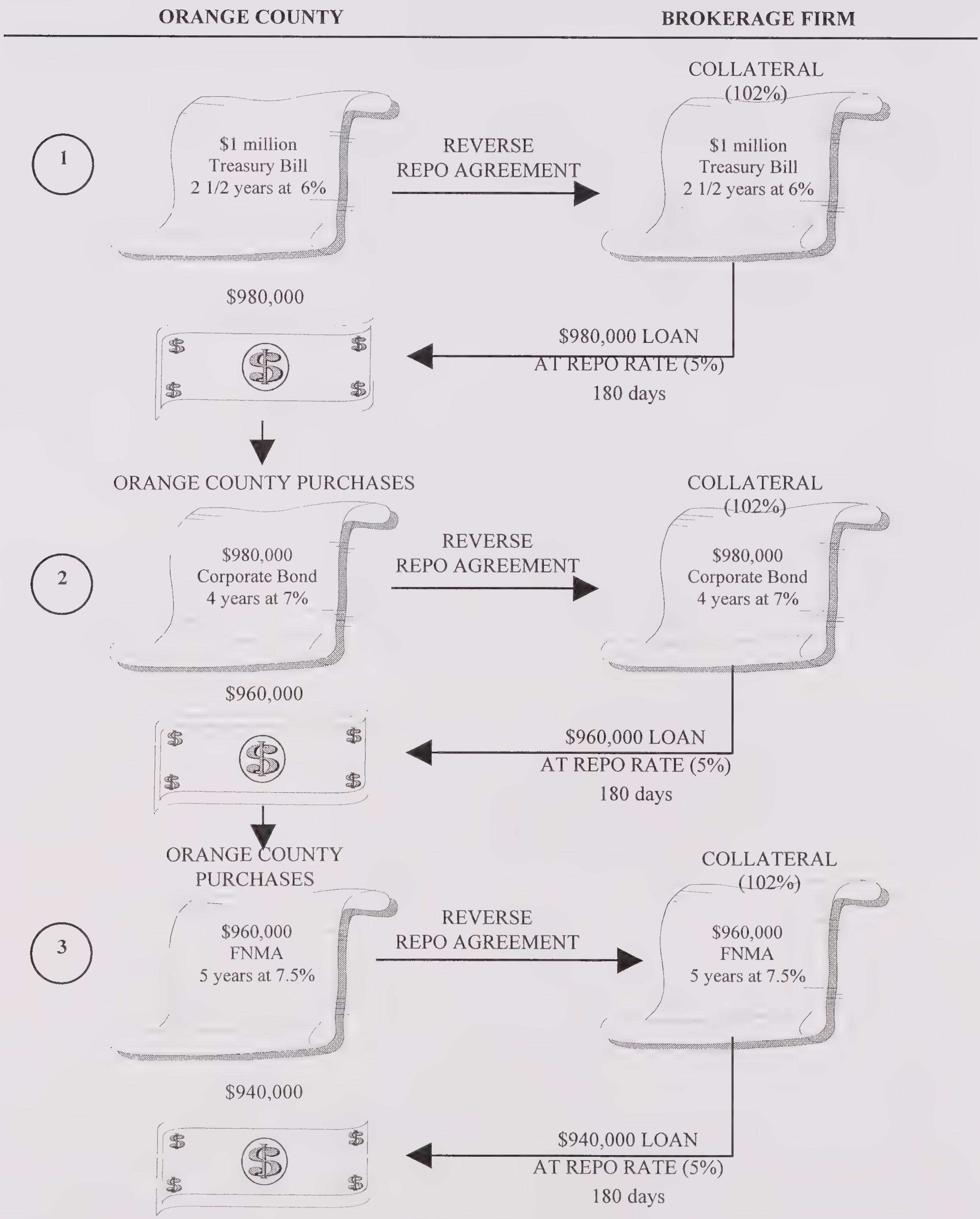
The following details the steps summarized in Figure 2:

Step 1: The county purchases a $1 million treasury bill that pays 6 percent interest and matures in two and one-half years. It uses the treasury bill as collateral and borrows money from a brokerage firm (broker) under a reverse repo that matures in 180 days. The county's cost of borrowing under the reverse repo is 5 percent. The broker, to protect its interests, requires the collateral to be in excess of what it loans the county. In this example, the broker requires collateral to be 2 percent higher than what it loans; thus, the amount of money that the county borrows is $980,000.

Step 2: Using the $980,000 that it borrowed, the county purchases a $980,000 corporate bond that pays 7 percent and matures in four years. It uses the corporate bond as collateral and borrows $960,000 from a broker under a 180-day reverse repo at a 5 percent cost of borrowing.

Figure 2

ORANGE COUNTY LEVERAGING METHOD



RECAP: Orange County has $3.88 million in assets and $2.88 million in loans (liabilities).

Brokerage firm has $2.94 million in collateral and $2.88 million in loans outstanding at 5 percent repo rate.

Step 3: Using the $960,000 that it borrowed, the county purchases a $960,000 Federal National Mortgage Association (FNMA) security that pays 7.5 percent and matures in five years. It uses the FNMA as collateral and borrows $940,000 from a broker under a 180-day reverse repo.

By the end of the example, the county has leveraged its original $1 million investment into $3.88 million in assets. However, the county also owes $2.88 million on the amount borrowed under the reverse repos. The reverse repo transactions in this example were profitable to the county because the interest rate that it earned with the investments that it purchased with the borrowed money was higher than the cost of borrowing. This difference is referred to as the "spread." However, the way in which the county was able to achieve such a favorable spread was by investing its borrowed monies in long-range investments that paid interest rates higher than the short-term borrowing rates. In 1994, when interest rates rose, causing borrowing costs to increase and the value of the securities purchased to decline, this approach failed.

The Overall Portfolio Was Highly Leveraged

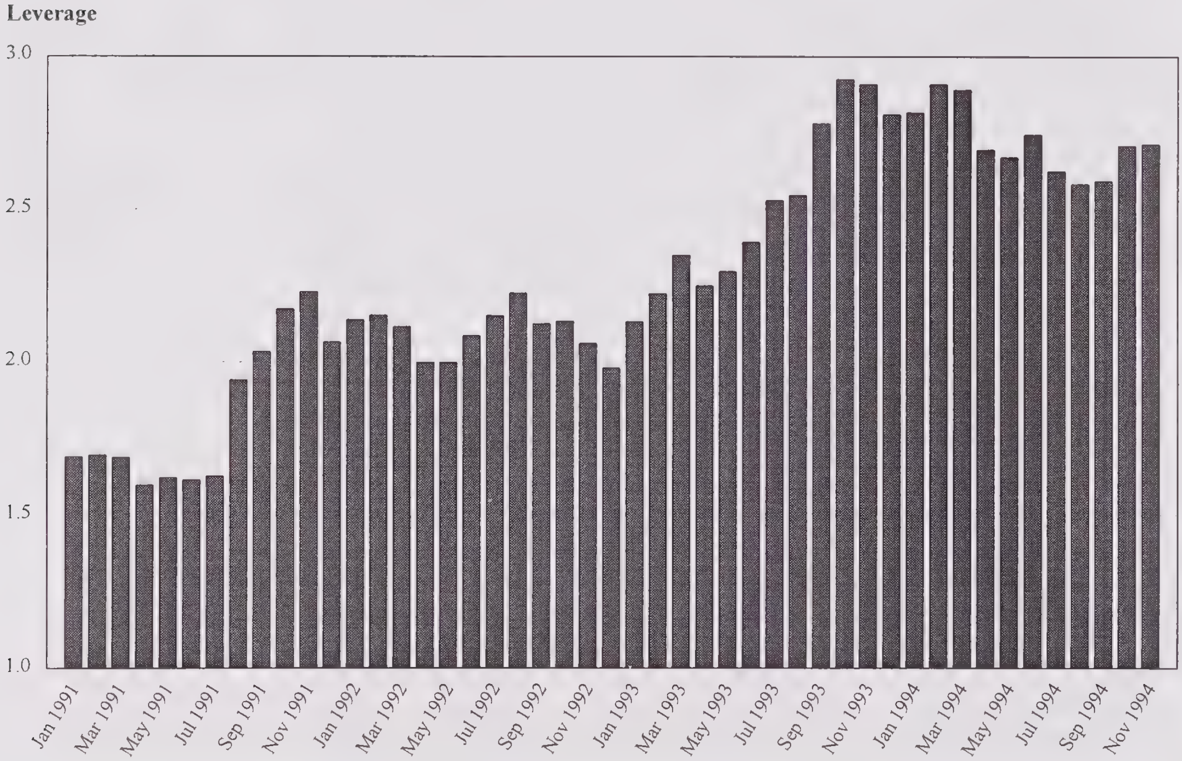
Treasurer leveraged original investment more than 270 percent.

A review of the investment portfolio at November 30, 1994, shortly before the bankruptcy, reveals the degree to which the portfolio was leveraged. By November 30, 1994, the former treasurer had leveraged the participants' original investment in the portfolio (base portfolio) of $7.6 billion to $20.6 billion in total investments. However, $13.0 billion, or nearly two-thirds of the $20.6 billion, represents investments borrowed against by using reverse repos. Thus, the portfolio was leveraged more than 270 percent, or 2.7 to 1 ($20.6 billion / $7.6 billion).

Our investment experts analyzed the extent to which the portfolio was leveraged from January 1991 through November 1994. As illustrated in Figure 3, the portfolio was leveraged throughout this period, ranging from a low of 160 percent, or 1.6 to 1, in April 1991 to a high of 290 percent, or 2.9 to 1, in October 1993. Generally, leverage dramatically increases the portfolio's exposure to risks related to interest rate changes. For example, the county's leveraging at November 30, 1994, magnified the impact of an interest rate change by 2.7 times on the base portfolio.

Figure 3

Orange County Investment Portfolio
Leverage of Portfolio—All Funds
January 1991 Through November 1994



Certain County Funds Were Leveraged Even More Significantly

The use of leveraging was even more dramatic when the former treasurer managed specific investments on behalf of the county's general fund in a separate account. He managed these investments separately as part of the county's plan to increase its revenues by specifically investing its funds for higher earnings. A review of the investments specifically managed for the county's general fund in the separate account indicates the use of extreme amounts of leverage.

For example, in January 1994, this separate account for the county's general fund was leveraged approximately 2,900 percent, or 29.0 to 1. The effect of this leveraging was to increase a base portfolio of approximately $100 million to $2.9 billion. Although the leverage in this account subsequently decreased, it was still as high as nearly 12.0 to 1 as late as August 1994. In the subsequent months, the county transferred securities from this separate account to the portfolio's commingled pool, where the investments of all participants were managed. We discuss the propriety of these transfers in Chapter 2.

Investment officers agree that reverse repos should be limited to a small percentage of the portfolio.

The former treasurer used reverse repos in an extreme and inappropriate manner for investing public funds. According to the Government Finance Officers Association's (GFOA) Committee on Cash Management, there are generally two basic uses for reverse repos. One is to use them as a way to avoid liquidating a portfolio to meet unexpected or immediate cash flow requirements. The second, and more controversial use, is for enhancing portfolio returns through the purchase of securities financed through reverse repos. However, the GFOA's Committee on Cash Management emphasizes that reverse repos should be used in a conservative and prudent manner. Furthermore, the California State Treasurer, the California Association of County Treasurers and Tax Collectors, and the Task Force on Local and State Investment Practices, all recommend that the use of reverse repos should be limited. These groups believe that leverage through reverse repos should be limited to a small percentage of the portfolio (e.g., 10 or 20 percent), a much smaller percentage than that used in the former treasurer's portfolio.

The Treasurer's Investment Tactics Were Unreasonably Risky

The California Government Code, Sections 53601 and 53635, allows local government investment officers great latitude in their investment practices. Specifically, the law allows the purchase of such securities as U.S. Treasury notes and bonds, bankers' acceptances, prime quality commercial paper, reverse repurchase agreements, and mortgage-backed securities. The inherent risks associated with these investments range from low-risk U.S. Treasury securities to higher risk notes structured from allowable securities. The former treasurer invested in government agency securities, repurchase agreements, corporate notes, commercial paper and foreign and domestic negotiable certificates of deposits (CDs), bankers' acceptances, and U.S. Treasury securities. For purposes of analysis and comparison, our investment experts evaluated the portfolio's investments in terms of the following asset classes:

- **Mortgage-backed securities:** Includes government agency securities, such as Federal Home Loan Bank (FHLB), Federal National Mortgage Association (FNMA), other U.S. government agency issues, and miscellaneous mortgage-backed securities. Investments classified in this category generally are longer term, fixed-rate securities that are not structured.

- **Floating rate notes:** Includes government agency securities, such as Student Loan Marketing Association (SLMA), FHLB and FNMA securities, and foreign negotiable CDs. Investments in this category generally carry variable rates and include derivative, or structured, notes.

- **Repurchase agreements (repos):** Short-term investments of available cash.

- **U.S. Treasury securities:** U. S. Treasury bills, notes, and bonds.

- **Agency:** Government agency issues not included elsewhere, including Federal Farm Credit banks, municipal notes, and Tennessee Valley Authority securities. This category of securities can include structured notes.

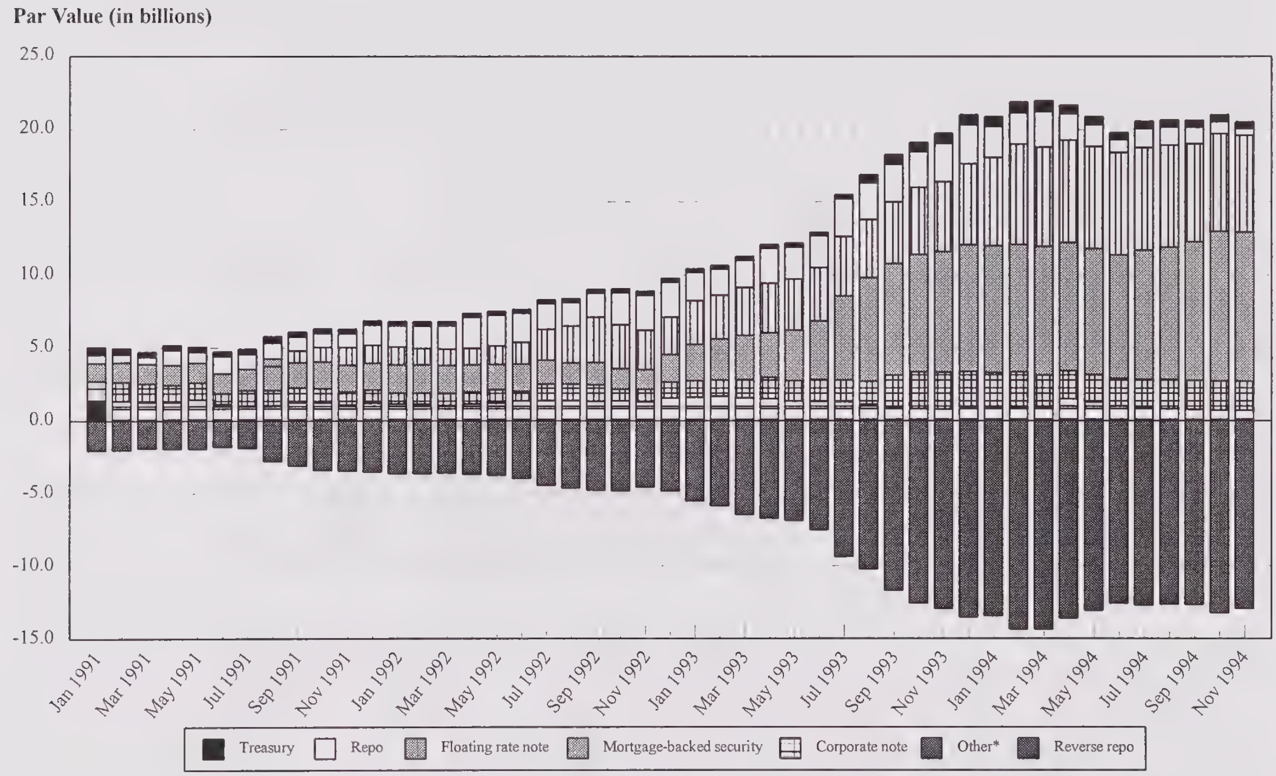
- **Corporate issues:** Corporate notes of medium term and high quality. This classification includes both structured and fixed notes.

- **Other:** Includes negotiable CDs (foreign and domestic, but not floating rate), bankers' acceptances, and commercial paper.

The composition of the county's investment portfolio from January 1991 through November 1994 is shown in Figure 4 on the following page. Because the asset classifications in the portfolio include securities purchased with money obtained with reverse repos, we have included reverse repos as a negative asset in this graph.

Figure 4

Orange County Investment Portfolio
Asset Allocation of All Funds
January 1991 Through November 1994



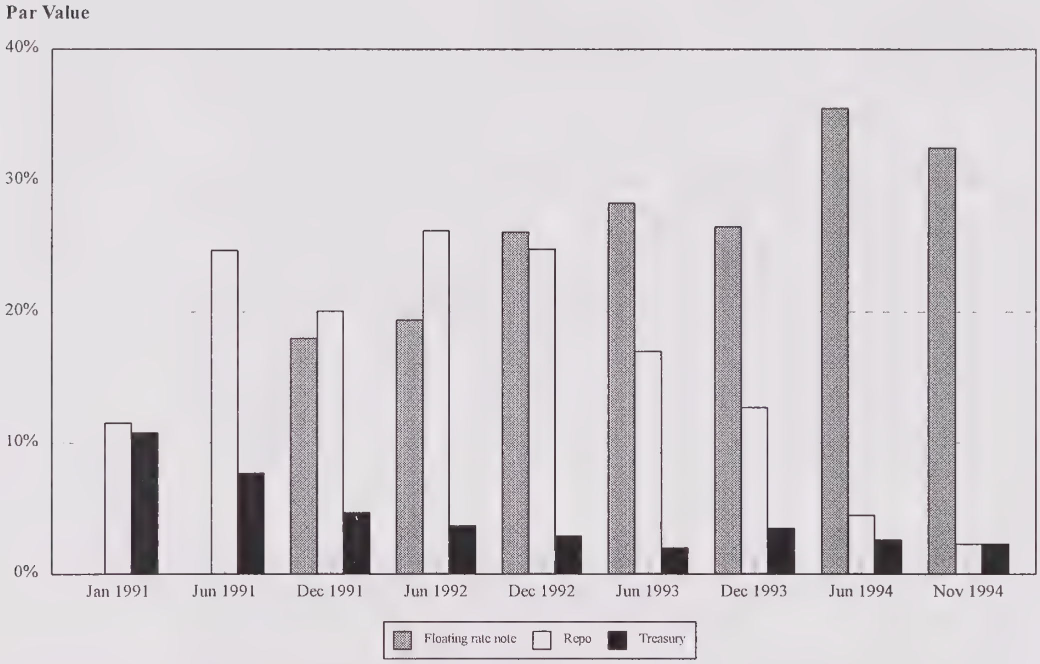
*Includes agency, commercial paper, bankers acceptance, certificate of deposit, and passbook.

The pattern of investments shifted dramatically from 1991 through 1994.

As shown, the pattern of investments shifted dramatically over the period covered. For example, as shown in Figure 5 on the next page, the proportion of low-risk U.S. Treasury securities fell from 11 percent in January 1991 to 2 percent by November 1994. Additionally, repurchase agreements, another relatively low-risk, short-term investment, fell from 25 percent of the portfolio in June 1991 to a mere 2 percent by November 1994. In contrast, the proportion of risky floating rate notes rose from 0 percent in January 1991 to 32 percent by November 1994. According to our investment experts, the asset allocation shift alone clearly indicates that the risk in the county's portfolio was increasing from 1991 forward.

Figure 5

Orange County Investment Portfolio
Change in Asset Allocation for All Funds
January 1991 Through November 1994



Note: Corporate note floaters are not included in the floating rate note category.

Treasurer invested $8.3 billion, more than 40 percent of his portfolio, in volatile structured notes.

Our investment experts performed an in-depth analysis of the portfolio as of November 30, 1994, shortly before the bankruptcy. The former treasurer had invested at least $8.3 billion, or more than 40 percent of his $20.6 billion portfolio, in structured notes, the vast majority of which were derivative securities. Derivative securities generally are described as financial instruments whose value is based on, or derived from, some underlying asset, reference rate, or index. Because of the volatility of these securities, they introduce substantial risk into the portfolio.

Derivative securities can be customized to suit the needs of particular investors. That is, they can be designed with features that reflect an individual investor's opinion on the future course of interest rates or other financial variables. They allow the purchaser to make a "bet" on interest rates. For example, if an investor predicts that interest rates will fall, derivative securities can be designed so that the return on the investment will rise if interest rates do, in fact, fall. However, if the prediction is incorrect and interest rates rise, the investment is affected adversely.

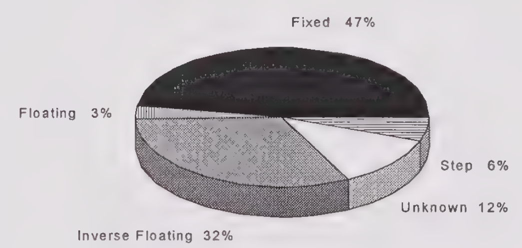
The predominant type of derivative securities that the county purchased was floating rate notes. In a straightforward floating rate note, the interest rate would vary according to a specified index, such as the London Interbank Offer Rate (LIBOR). However, the vast majority of the former treasurer's floating rate securities were of a more complex variety, known as inverse floaters. The interest rate on inverse floaters moves in the opposite direction from the underlying index. For example, a specific inverse floater may have an interest rate of 9 percent, less the six-month LIBOR. In this case, if LIBOR were 3 percent, the security would earn 6 percent. However, if LIBOR increased to 5 percent, the security's interest rate would drop to 4 percent.

Treasurer bet on interest rates remaining low by investing at least 32 percent of his portfolio in inverse floaters.

According to our investment experts' analysis, as shown in Figure 6, the former treasurer's portfolio carried at least \$6.6 billion, or 32 percent, in inverse floaters on November 30, 1994. He also invested a minimum of \$1.7 billion, or 9 percent, in other forms of structured notes, namely step, or step-up, notes and floating rate securities other than inverse floaters. On November 30, 1994, the county's derivative and other structured notes may have been even higher. Our investment experts were able to review the detailed security descriptions (term sheets) for only 88 percent of the investments.

Figure 6

Orange County Investment Portfolio
Investment Type Breakdown for All Funds
November 1994



Source: Percentages based on information from available term sheets.

High proportion of structured securities substantially increased the portfolio's risk and impaired its liquidity.

Our investment experts state that the high proportion of structured securities in the portfolio substantially increased risk and impaired its liquidity. By investing substantially in inverse floaters, the former treasurer was betting that interest rates would remain low or fall. However, during 1994, interest rates rose sharply, causing a steep decline in the portfolio's value. Often, investors in structured notes hedge their bets by entering into offsetting transactions to limit their risk should their predictions turn out to be wrong. In the county's portfolio, our investment experts found no significant evidence of offsetting transactions.

In a September 1993 report to the board of supervisors, the former treasurer claimed to be hedging against an eventual interest rate rise by purchasing fixed rate notes. He stated, "Although we strongly believe that future interest rates will remain low, to insure against the eventuality of materially rising interest rates, for the last six months we have not been buying structured/floating interest rate instruments but have been purchasing fixed interest rate coupon instruments." However, despite the former treasurer's claim, according to our investment experts' analysis, he had purchased inverse floaters totaling over $340 million during the six-month period before his statement and purchased an additional $350 million in inverse floaters from the date he made the statement to the end of September 1993.

Despite claims to the contrary, the treasurer continued to buy inverse floaters totaling over $690 million.

Furthermore, our investment experts concluded that holding structured notes also may negatively affect the liquidity of the portfolio. Because most structured notes are custom designed by brokers acting as intermediaries between the issuers and purchasers and are privately sold, they are difficult to sell to another investor. Although liquidity was a primary objective of the county's investment policies, the former treasurer violated his policy by investing heavily in these illiquid derivatives.

The Treasurer Borrowed Short To Buy Long

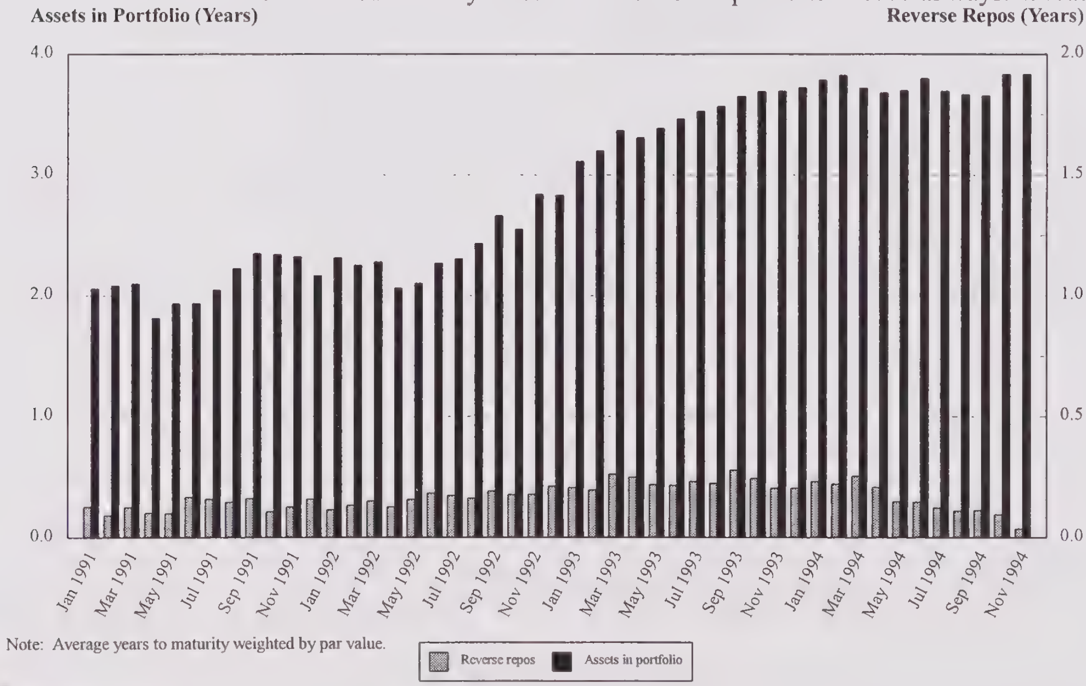
In addition to risks incurred by purchasing derivatives, the former treasurer also exposed the portfolio to significant risk by buying long-term securities with short-term borrowing. His incentive for doing so was to obtain the higher rate of return available on longer term investments and to profit from the spread between the investment's earnings and the costs of borrowing. According to the GFOA's Committee on Cash Management, the conservative and prudent approach to borrowing with reverse repos is to match the maturity date of the asset purchased with the due date of the reverse repo. At one time, the former treasurer agreed with this approach of matching maturity dates. In a 1985 letter, he commented that the reverse repos he used were fail-safe because the investments he made with the borrowed funds matured on the same date as the reverse repo; therefore, he always had the funds to pay them off. Furthermore, in his statement of investment policy for fiscal year 1988-89, he claimed that by matching the maturities on the reinvestment of the proceeds to the maturities on the reverse repos, he maintained safety and liquidity.

The treasurer's "fail-safe" practice of matching maturities changed dramatically—matched positions were rare.

However, the former treasurer apparently changed his approach. As reflected in Figure 7, our investment experts concluded, based on their analysis of the portfolio, that perfectly matched positions were rare. In 1994, the average maturity of the reverse repos, which comprised more than 60 percent of the portfolio, was considerably less than half a year. In contrast, the average years to maturity of the total portfolio was nearly four years.

Figure 7

Orange County Investment Portfolio Comparison of Average Years to Maturity for Reverse Repos and Assets Held in All Funds



Note: Average years to maturity weighted by par value.

Unmatched maturity dates cause risk to the portfolio in several ways. Because reverse repo borrowing rates are guaranteed only for short time periods (e.g., 180 days or less) and the rate of the security purchased is for a much longer period (e.g., two to four years), then the investor must continually borrow at the current rates until the security matures. Increases in short-term interest rates translate into higher reverse repo borrowing costs, thus reducing, or even eliminating, the spread between the borrowing costs and investment returns.

Borrowing short and buying long subjects the portfolio to interest rate risks and collateral calls.

In addition, borrowing short and buying long, with the resultant requirement to continually borrow, exposes the portfolio to increased risk of collateral calls because the assets pledged may lose value. As discussed earlier, when a broker lends money under a reverse repo, the broker requires collateral in excess of the amount lent to protect its interests. If the market value of the collateral declines, the broker can send a call to the borrower requiring additional assets to restore the collateral to its original level. Collateral calls can place untimely and significant demands on a portfolio by draining its cash

or equivalent securities or by requiring the premature liquidation of other assets.

The Treasurer's Reckless Investment Strategies Resulted in the Loss of $1.69 Billion in Public Funds

Treasurer's portfolio was significantly more risky than comparable funds.

The former treasurer's tactic of highly leveraging the portfolio, coupled with the purchase of higher risk, interest-sensitive investments, amplified the pool's vulnerability to interest rate increases. According to our investment experts, the former treasurer's portfolio was significantly more risky than funds with comparable objectives. Further, the portfolio was so sensitive to interest rate changes that the actual changes in interest rates that occurred during 1994 would have caused a 22.2 percent loss to the participants' original investment in the portfolio (base portfolio) by November 30, 1994. These high-risk strategies ultimately caused a $1.69 billion loss to the portfolio and led the county into bankruptcy.

To assess the portfolio's sensitivity to interest rate fluctuations, our investment experts employed an analytical technique called "duration." Duration provides a quantitative measure of the portfolio's sensitivity to a 1 percent interest rate change. A portfolio that does not put principal at risk as interest rates move, such as one exclusively invested in a passbook savings account, has a duration of essentially zero. However, as investments are made in longer term instruments, and when leverage and structured notes are added to the portfolio, the duration increases to reflect increased sensitivity to interest rate fluctuations.

The combination of increased maturities, leverage, and structured securities more than tripled the portfolio's vulnerability to interest rate increases.

Our investment experts found that the combination of increased maturities, leverage, and structured securities more than tripled the portfolio's vulnerability to interest rate increases from June 1991 to June 1994. Specifically, the base portfolio's duration ranged from 2.7 in June 1991 to 8.6 in June 1994. To determine the specific impact at these dates, the duration must be multiplied by the actual change in interest rates.

In comparing the former treasurer's portfolio to that of typical funds with comparable objectives, our investment experts found that the former treasurer's portfolio was significantly riskier. Specifically, the duration of his portfolio was four times higher than the comparable funds. Our investment experts determined that, based on the former treasurer's stated investment objectives, the county's investment style should provide a short-term, high-quality investment portfolio to meet the needs of the participants. The duration of the comparable investment portfolios was 1.8, whereas the duration of the former treasurer's portfolio was 7.4 at November 1994. Furthermore, funds designed specifically for higher risk investing, those holding low-quality, high-yield securities, had a duration of 4.5, still significantly less than the former treasurer's portfolio.

In addition, the former treasurer's investments in structured securities were seven times greater than the comparable funds. Specifically, comparable funds that invest in structured securities carried only 5.9 percent of their portfolio in structured notes, while the former treasurer carried more than 40

percent. Additionally, many of these funds do not invest in structured notes at all.

Because the portfolio was exposed to the risk that interest rates would rise, our investment experts calculated the decline in par value of the base portfolio that would result from a 1 percent increase in market interest rate to illustrate the effect of leverage and structured securities on the value of the portfolio. They found that even a 1 percent increase in interest rates on November 30, 1994, would result in a $560 million loss to the base portfolio. Based on interest rate increases that actually occurred during 1994, they calculated that the portfolio would lose an estimated $1.68 billion, remarkably close to the amount the county actually lost.

Conclusion

Orange County's losses provide a sobering example of what can happen when a public official loses sight of the fundamental principles of prudent investing.

The former treasurer's irresponsible investment strategies caused a $1.69 billion loss to an investment portfolio he managed on behalf of the county and 190 other public agencies. Ultimately, his excessive use of reverse repos and derivative securities had far-reaching effects, including bankruptcy, layoffs, potential cutbacks in critical services, and losses to other public entities that issued taxable debt for the sole purpose of investing in the portfolio. These devastating losses provide a sobering example of what can happen when a public official loses sight of the fundamental principles of prudent investing.

The former treasurer implemented investment practices diametrically opposed to the portfolio's objectives by increasingly investing in longer term, lower quality, higher risk investments. He sacrificed safety and liquidity in a failed strategy to capture higher yields.

His investment tactics were based largely on betting on the future direction of interest rate trends. By borrowing short and investing long and purchasing inverse floaters, the former treasurer wagered that the market's expectation of future interest rates was incorrect and that his expectation that rates would not rise was correct. By July 1994, the treasurer knew, or should have known, that his strategy had backfired because by then, interest rates had been climbing steadily.

Chapter 2

The Treasurer Violated the Public Trust

Chapter Summary

The former treasurer of Orange County (county) violated the public trust by imprudent investing, altering accounting records, misallocating interest earnings and investment losses, and by treating certain participants in a preferential manner to the detriment of others. As a result of these imprudent actions, the funds invested by public officials and public entities suffered significant losses. Specifically, the county's general fund received approximately $93 million more in interest earnings than it was entitled to receive and benefited by the transfer of $271 million in losses to the pool participants. Also, because of guarantees made to certain participants, the other pool participants incurred a $27 million market value loss to the portfolio.

The treasurer violated the public trust by imprudent investing, altering accounting records, and misallocating investment earnings and losses.

By Imprudent Investing, the Treasurer Violated His Trust Responsibilities

As an official entrusted with the safekeeping and management of public funds, the former treasurer was required to be a prudent investor. However, the former treasurer violated his trust responsibilities by taking excessive investment risks. These excessive risks, described in Chapter 1 of this report, include significantly leveraging the portfolio through reverse repurchase agreements and investing in a large number of higher risk structured securities that would be profitable only if interest rates did not rise. As a result of his imprudent actions, the funds invested by cities, schools, and other public entities suffered significant losses.

The former treasurer had a trust responsibility to all 190 participants in the county's investment portfolio. The California Government Code, Section 27000, states that the county treasurer is required to receive and safely keep all funds deposited. Also, Section 27100.1 of the code creates a trust relationship between the treasurer and public entities or public officials who are acting in a fiduciary capacity when they deposit funds into the county treasury. According to our legal counsel, when investing trust funds under Section 27100.1, the treasurer has the duty to be a prudent investor.

As of November 30, 1994, the 190 public agencies, including the county, cities, special districts, and school districts, had approximately $7.6 billion on deposit with the treasurer. Many of these entities were required by law to invest their funds with the treasurer. For example, Section 41001 of the California Education Code generally requires school districts to pay all monies received or collected from any sources into the county treasury. Other public agencies voluntarily deposited their monies into the county's treasury as permitted by the Government Code, Section 53684. However, whether the deposits were required or voluntary, a trust relationship was established between the treasurer and the public entity when the agency deposited funds into the county treasury.

Among the county public agencies investing funds in the former treasurer's portfolio were the public administrator, the public guardian, and the clerk of the superior court. Our legal counsel states that a trust relationship exists with each of the entities.

Treasurer had a trust responsibility to protect funds deposited on behalf of decedents, public guardians, and 430 minors.

The county public administrator protects a decedent's property from waste, loss, or misappropriation. When the public administrator takes possession of the decedent's money, Section 7640 of the California Probate Code allows the public administrator to deposit monies with the county treasurer. As of December 6, 1994, the public administrator's deposits with the county treasurer totaled approximately $9.2 million.

The California Probate Code requires the public guardian to arrange for the personal care of the finances of persons who have been found by the court to be unable to handle their affairs. As with the public administrator, when the public guardian deposits monies with the county treasurer, a trust relationship is established. As of December 6, 1994, the county public guardian had on deposit approximately $7.5 million with the county treasurer.

Furthermore, as of December 8, 1994, the clerk of the county superior court had on deposit with the treasurer approximately $6.9 million on behalf of approximately 430 minors. The county superior court administers a program for minors who have received monies from legal actions. Generally, the

county holds the monies until the minors reach age 18. The county treasurer invests the monies to earn interest as required by the California Probate Code.

The Treasurer's Office Overallocated Investment Earnings to the County

By altering accounting records, the county's general fund received $93 million more than it was entitled.

The treasurer's office altered accounting records, which allowed the county's general fund to receive approximately $93 million more in interest earnings than it was entitled to receive, to the detriment of the other participants. Specifically, the treasurer's office inappropriately transferred interest revenue from the unapportioned interest fund to the benefit of the county's general fund. The treasurer's office uses the unapportioned interest fund to hold earnings on investments from the commingled investment pool (commingled pool), until they are apportioned to the appropriate recipient. The county uses the general fund to account for monies used for the general operations of the county. As previously discussed in the Introduction, the commingled pool is one of the components of the treasurer's investment portfolio.

The California Government Code, Section 53684(b), requires county treasurers to apportion any interest from the investment of funds quarterly in an amount proportionate to the average daily balance of the amounts deposited by the local agency and district.

The treasurer's office policy is to calculate interest earnings at the end of each month by determining the average daily balances of the amounts on deposit for each participant (dollar days). The monthly dollar days for each participant are divided by the total dollar days for all participants. This percentage is then multiplied by the total amount of interest earned during the month. For example, an account balance of $100 invested for 30 days equals 3,000 dollar days. If the dollar days for all participants totals 10,000, the participant in this example would receive 30 percent (3,000 ÷ 10,000) of the total interest. The dollar days for each participant are summarized in a monthly interest revenue allocation report and in other monthly allocation reports. The dollar days balances should be the same on every report. Interest earnings to be allocated to each participant are reported on the interest revenue allocation report. This report is the basis for notifying the county auditor-controller of the amount to be transferred to each participant.

To determine the extent of the inappropriate allocations of interest to the county's general fund, we compared the dollar days balances of the general fund for the period July 1992 through October 1994 between the interest revenue allocation report and one of the other allocation reports that uses dollar days balances. The county's general fund receives not only the interest revenue earned on general fund monies invested, but also the interest revenue earned by certain other county funds, such as various county trust funds. We also determined the accuracy of the monthly dollar days balance information for the general fund by reviewing the daily cash balances and recalculating the monthly dollar days balances. We then recalculated the interest that should have been apportioned to the general fund. We did not verify the accuracy of the total monthly interest earnings on investments in the commingled pool.

Two methods were used to misallocate interest earnings.

Table 3 on the next page presents a summary of the interest allocated erroneously to the county's general fund.

The treasurer's office misallocated approximately $93 million of interest revenue in two different ways. First, after the interest allocation calculations were complete, the treasurer's office inflated the amount allocated to the general fund on the interest revenue allocation report. Modifications of interest allocations using this method occurred each month during the period April 1993 through July 1993. For example, in June 1993, the amount of interest that should have been allocated to the general fund based on dollar days was approximately $2.0 million. However, the amount of interest that was allocated based on the interest revenue report was approximately $7.1 million, resulting in an overallocation of approximately $5.1 million.

The second way that the treasurer's office inappropriately allocated interest revenue was by manipulating the dollar days balances applicable to the general fund in the interest revenue allocation report. For each month during the periods July 1992 through July 1993 and July 1994 through October 1994, the dollar days balances among the various types of allocation reports were identical. Beginning in August 1993, and continuing through June 1994, we found significant differences between the dollar days balances in the interest revenue report and those in another report. For example, in November 1993, the dollar days balance for the general fund reflected in one allocation report was a negative amount of approximately $2.3 billion. Negative dollar days could occur when a fund is overdrawn for most of the month. However, the dollar days balance included in the interest revenue allocation report for the general fund had been increased to approximately $60.4 billion.

Table 3

Summary of Interest Earnings Overallocated to the County's General Fund April 1993 Through June 1994 (in millions)

Month	Interest That the County's General Fund Should Have Received	Amount of Interest the County's General Fund Actually Received	Overallocation of Interest to the County's General Fund
April 1993	$ 1.5	$ 5.3	$ 3.8
May	1.9	5.4	3.5
June	2.0	7.1	5.1
July	3.1	6.8	3.7
August	1.5	10.2	8.7
September	1.1	10.7	9.6
October	1.2	10.0	8.8
November	0.7	14.0	13.3
December	0.8	8.4	7.6
January 1994	0.4	10.6	10.2
February	2.3	15.3	13.0
March	2.3	3.5	1.2
April	2.3	3.7	1.4
May	2.4	4.1	1.7
June	2.5	3.8	1.3
Total	**$26.0**	**$118.9**	**$92.9**

In February 1994, one allocation report indicated that the dollar days balance for various county trust funds attributable to the general fund was approximately $5 billion, but the dollar days balance recorded in the interest revenue allocation report had been increased to approximately $60.9 billion. Moreover, during the period February through June 1994, negative dollar days balances for the general fund were omitted, thus artificially inflating the dollar days attributable to the general fund.

We were unable to determine who was responsible within the former treasurer's office for the alterations in the accounting records or the reasoning behind the changes because the treasurer's staff was put on administrative leave. Further, we know of no reason why the county's interest allocations would not be based on dollar days. However, the county has indicated that the omission of the negative dollar days during the period February through June 1994 was a result of a computer programming error. We have been unable to verify this information.

Because the treasurer's office altered the records used to allocate interest earnings, the county's general fund received approximately $93 million more in interest earnings than it was entitled to receive.

A Special Fund Established for the Treasurer's Office Inappropriately Received Interest Earnings

The treasurer's office inappropriately transferred approximately $15.4 million of interest earnings (earnings that should have been allocated to the commingled pool participants) from the unapportioned interest fund to the treasurer's commingled investment pool reserve fund (fund 9JJ). The unapportioned interest fund is used to hold interest earnings until they are allocated to the pool participants. The county auditor-controller's office established fund 9JJ during June 1994 at the request of the former treasurer. The request did not provide a description of the intended use of fund 9JJ except that it was a new fund for the treasurer.

The treasurer's special fund received interest belonging to the pool participants.

On June 30, 1994, the treasurer's office inappropriately transferred approximately $15.4 million in interest earnings from the unapportioned interest fund into fund 9JJ instead of allocating these monies to the commingled pool participants. Subsequently, during August 1994, the treasurer's office transferred approximately $4.1 million from fund 9JJ back into the unapportioned interest fund. We were unable to determine if the $4.1 million in interest earnings was included in the April through June quarterly distribution to the commingled pool participants in September 1994. In October 1994, the treasurer's office transferred an additional $8.5 million from fund 9JJ back into the unapportioned interest fund. Because the county has not made any quarterly distributions of interest earnings to the commingled pool participants since September 1994, this amount has remained in the unapportioned interest fund. As of January 31, 1995, a balance of approximately $2.8 million remained in fund 9JJ. Further, the county still holds at least $11.3 million and possibly as much as $15.4 million in interest earnings that should have been allocated to the commingled pool participants.

The Treasurer's Office Transferred County Investment Losses to the Commingled Pool

The treasurer's office transferred securities that had lost approximately $271 million in market value from the county general fund's specific investment account (specific investment account) to the commingled pool, where the losses would be shared by all pool participants. The former treasurer invested certain general fund monies separately from the commingled pool. As of August 31, 1994, the specific investment account portfolio contained 52 securities with a book value of approximately $2.616 billion offset by 34 reverse repurchase agreements with a book value of approximately $2.385 billion. An additional two securities were subsequently purchased. However, by November 30, 1994, the specific investment account had a zero balance. A review of the treasurer's records revealed that the securities and the related reverse repurchase agreements were transferred from the specific investment account to the commingled pool.

To determine the timing and nature of these transfers, we compared the investment inventories for the period September through November 1994 for the specific investment account and the commingled pool. We then obtained an estimate of the market value for each security from our investment experts. The majority of these securities were valued at the time of transfer using various pricing service firms. If market prices were unavailable from these firms, our investment experts obtained prices of comparable bonds and securities with similar coupon rates and maturity dates. Also, certain securities were valued using actual sales information.

The treasurer shifted $271 million in county losses that were then shared with all pool members.

As illustrated in Table 4, during the period we reviewed, 54 securities were transferred from the specific investment account to the commingled pool at book value, thereby shifting approximately $271 million of losses in market value to the pool participants. Although these types of transactions may have occurred in other months, our review focused on the period September through November 1994.

Table 4

Summary of Securities Transferred From the County's Specific Investment Account to the Commingled Pool September 1994 Through November 1994 (dollar amounts in millions)

Month	Number of Securities Transferred	Book Value	Estimated Market Value at Time of Transfer	Loss
September	14	$ 650	$ 595	$ 55
October	13	395	353	42
November	27	2,170	1,996	174
Total	**54**	**$3,215**	**$2,944**	**$271**

We were unable to determine the reasons for making these transfers because the former treasurer's office staff had been put on administrative leave. Further, although the county records normally provide an explanation for these types of transactions, the records failed to document a reason for the transfers. Although recording securities at book value within funds has been an accepted practice, all the securities transferred during this period declined significantly in market value. Declines in market value become actual losses when the securities are sold. Because the portfolio was liquidated, the loss in market value for the securities was realized. Therefore, investment losses of at least $271 million from the specific investment account that belonged solely to the county's general fund were absorbed by all commingled pool participants.

The Treasurer Treated Participants Inconsistently

The former treasurer was inconsistent in his treatment of the members participating in the portfolio. For example, the treasurer's office made guarantees to certain participants to the detriment of the others.

As previously discussed in the Introduction, several participants issued taxable notes during 1994 to invest the proceeds in the portfolio. Four of these participants also issued taxable debt during 1993, including Irvine Unified School District, Newport-Mesa Unified School District, North Orange County Community College District, and the Orange County Board of Education. We found that the treasurer's office guaranteed two of the four participants that when their taxable notes became due at the end of one year, the treasurer's office would buy the investments at the participant's original purchase price. This arrangement allowed the participants to receive interest earnings throughout the year without sharing in the risk of any potential market loss

when the securities were sold. Further, we found that the other two participants had been given verbal guarantees from the former assistant treasurer that the principal invested was not at risk.

The treasurer's office gave guarantees to selected pool members that protected their investments from loss.

The treasurer's office gave written guarantees to two of these participants. For example, on July 13, 1993, the former assistant treasurer wrote to Newport-Mesa Unified School District. In this letter, the former assistant treasurer outlined the investments to be made with the proceeds from the taxable notes and discussed the potential interest earnings. He also guaranteed the district that when the district's taxable notes became due on June 15, 1994, the county would buy the securities from the district at the price originally paid. The former assistant treasurer gave further assurances that although the district would not share in any market gain, it also would not have the risk of any market loss in connection with the sale of the securities. Additionally, before a senate special committee, the superintendent of schools for Newport-Mesa Unified School District testified that during a meeting held on April 7, 1994, the former assistant treasurer indicated that his office would be willing to provide the same guarantee for a second issuance of notes. The former assistant treasurer also wrote to North Orange County Community College District on October 18, 1993, and provided these same guarantees.

The county purchased the securities from these four participants on June 15, 1994, at the original purchase price. The county then transferred these securities into the commingled pool at their book value. Book value at the time of purchase was approximately $395 million. However, the market value of these securities had declined since the date they were purchased for the original four participants. Our investment experts estimated that on June 30, 1994, the securities had a market value of approximately $375 million, a $20 million loss. Because of the former assistant treasurer's guarantees, the original four participants did not bear the $20 million loss in market value related to the securities. Rather, the potential loss was shifted to the participants in the commingled pool.

In another example of inconsistent treatment of pool participants, the former treasurer wrote to the City of Laguna Beach in November 1993 proposing a special investment arrangement. In this letter, the former treasurer stated that he had sent the former assistant treasurer to meet with city officials to propose an investment strategy designed to generate additional interest income to offset losses that the city had incurred during a firestorm. This strategy involved the former treasurer's purchasing a security on behalf of the city and executing a simultaneous reverse repurchase agreement. The former treasurer also guaranteed the city that it would have no principal risk on the transaction and that at the end of one year he would purchase the security at the city's cost. Furthermore, the former treasurer stated that he had not offered this type of arrangement to other pool participants because its overuse could negatively affect the portfolio's liquidity.

Because of the guarantees, all pool participants bore $27 million in losses from five selected members.

The former treasurer purchased the security from the City of Laguna Beach on June 15, 1994, approximately six months after the original purchase by the city. The county then transferred the security into the commingled pool at book value, which was $50 million. Based on the information received from our investment experts, the market value for this security had declined since the date it was purchased to approximately $43 million, resulting in a $7 million loss. Because of the former treasurer's guarantee, the City of

Laguna Beach did not incur the $7 million loss. Instead, the potential loss was transferred to the participants in the commingled pool.

Conclusion

The former treasurer violated his trust responsibilities to participants who invested their funds in the county treasury. For example, the treasurer's office altered county accounting records for investment pool interest earnings. As a result, the county received approximately $93 million more of interest earnings than it was entitled to receive, to the detriment of the other commingled pool participants. Further, the treasurer's office inappropriately transferred approximately $15.4 million in interest earnings that belonged to participants in the commingled pool. Moreover, the treasurer's office improperly transferred securities from the county's specific investment account to the commingled pool. As a result, the county transferred its loss of $271 million to the members of the commingled pool. Finally, because the treasurer's office provided risk-free investment guarantees to five participants, the commingled pool members +sustained a $27 million loss.

Chapter 3

Fees and Expenses Related to Debt Issues, Investment Activities, and Bankruptcy at Orange County

Chapter Summary

We reviewed 9 short-term debt issues at the Orange County (county) treasurer's office and 14 long-term debt issues at the county administrative office. The total amount of the debt was approximately $2.859 billion for 1993 and 1994. Approximately $13.77 million was incurred for underwriters, bond counsels, and financial advisors. We limited our review of debt to issues for which the board of supervisors or the treasurer's office selected the underwriters, bond counsels, and financial advisors.

In addition, eight brokerage firms reported that they had revenues of at least $21.3 million in 1994 and $46.3 million in 1993 from financial transactions with the county. Another six firms did not provide information on the amount of revenue that they earned from the county.

The county estimated that approximately $23.7 million will be spent for bankruptcy-related costs through June 30, 1995. The county has not yet estimated costs beyond June 30, 1995. It retained 10 firms to provide various services, including legal services for the bankruptcy, litigation services, and

financial advisory services. In addition, the county will pay an estimated $545,000 through June 30, 1995, for legal representation for current or former county employees.

Background

The county issued short-term debt through the treasurer's office and long-term debt through the county administrative office (CAO). We reviewed debt issues totaling approximately $2.859 billion for 1993 and 1994. The county incurred costs of approximately $13.77 million for various professional services on these debt issues from underwriters, bond counsels, and financial advisors.[1] We limited our review of debt issues to underwriters, bond counsels, and financial advisors that the board of supervisors or treasurer's office selected.

Short-Term Debt Not Bid at the Treasurer's Office

Nine firms earned $3 million on short-term debt.

We reviewed nine short-term debt issues that the treasurer's office issued. Approximately $3.031 million was incurred for costs relating to underwriters, bond counsels, and financial advisors, also known as financial and marketing specialists. The treasurer's office did not competitively select all professional services on these debt issues. For example, the treasurer's office negotiated for underwriter services on all nine issues. We were unable to determine the procedures employed for selecting underwriters or the process followed for negotiating the fees.

Underwriting is the purchasing of the county's debt issues by a brokerage firm that then sells the bonds or debt issues to investors. The underwriter's fee is the difference between the price the underwriter paid for the debt and the price at which it sold. Debt may be sold to underwriters through negotiated sale or competitive bidding. In negotiated sales, the treasurer selects the underwriters before the debt is sold.

As Table 5 shows, the brokerage firms received $2.9 million for underwriting the short-term debt. For short-term debt, the underwriters paid approximately 75 percent of their fees to the financial and marketing specialist. For example, on the $400 million taxable notes, the underwriter, PaineWebber, Inc. paid $388,000 to the financial and marketing specialist, Leifer Capital, Inc. from the underwriter's fee of $488,000.

For three debt issues, the treasurer's office selected Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch). Merrill Lynch received underwriting compensation of $1,074,500, which represented 37 percent of all underwriting fees. In addition, Merrill Lynch and Smith Barney, Inc. received $195,000 for a joint underwriting on a flood control district taxable note. The treasurer's office selected PaineWebber, Inc. for three debt issues for which PaineWebber, Inc. received $1,072,840 for underwriting fees.

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[1] The county also incurred other costs for issuing debt, such as fees for rating agencies and printers. We have not included these costs in this report.

Table 5

Costs for Underwriters, Bond Counsels, and the Financial and Marketing Specialist for Short-Term Debt Calendar Years 1993 and 1994

Description of the Debt	Underwriter Selected	Underwriter Fees (Including Financial and Marketing Specialist Fees)	Bond Counsel Selected	Bond Counsel Fees[a]	Financial and Marketing Specialist Selected	Financial and Marketing Specialist Fees Paid by Underwriters[d]
1993 Debt Issues						
$400 million Taxable Notes	PaineWebber, Inc.	$ 488,000	Buchalter, Nemer, Fields & Younger	$ 25,000	Leifer Capital, Inc.	$ 388,000
$136 million Tax and Revenue Anticipation Notes, Series A	PaineWebber, Inc.	331,840	Buchalter, Nemer, Fields & Younger	25,697	Leifer Capital, Inc.	297,651
$215 million Teeter Plan Taxable Notes	Citicorp Securities, Inc.	507,500	Buchalter, Nemer, Fields & Younger	0[b]	Leifer Capital, Inc.	400,000
1994 Debt Issues						
$169 million Tax and Revenue Anticipation Notes, Series A	PaineWebber, Inc.	253,000	LeBoeuf, Lamb, Greene & MacRae	8,700	Leifer Capital, Inc.[c]	210,750
$600 million Taxable Notes	Merrill Lynch, Pierce, Fenner & Smith, Inc.	780,000	LeBoeuf, Lamb, Greene & MacRae	8,700	Leifer Capital, Inc.[c]	480,000
$111 million Teeter Plan Taxable Notes	Merrill Lynch, Pierce, Fenner & Smith, Inc.	166,500	LeBoeuf, Lamb, Greene & MacRae	8,000	Leifer Capital, Inc.[c]	111,000
$100 million Flood Control District Taxable Notes	Smith Barney, Inc. and Merrill Lynch, Pierce, Fenner & Smith, Inc.	195,000	LeBoeuf, Lamb, Greene & MacRae	20,355	Leifer Capital, Inc.[c]	145,000
$31 million Tax and Revenue Anticipation Notes, Series B	Bear, Stearns & Co., Inc.	68,200	LeBoeuf, Lamb, Greene & MacRae	8,200	Leifer Capital, Inc.[c]	52,700
$64 million Teeter Plan Tax-Exempt Notes	Merrill Lynch, Pierce, Fenner & Smith, Inc.	128,000	LeBoeuf, Lamb, Greene & MacRae	8,000	Leifer Capital, Inc.[c]	91,200
Total $1,826,000,000		**$2,918,040**		**$112,652**		**$2,176,301**

[a] In addition to the bond counsel fees listed in the table, LeBoeuf, Lamb, Greene & MacRae earned $16,681 for general services related to debt issues.

[b] The county did not receive an invoice for legal services for the $215 million Teeter Plan Taxable Notes and therefore did not pay the law firm.

[c] Rauscher Pierce Refsnes, Inc. earned $10,000 as a pricing consultant on each of the six 1994 debt issues.

[d] The costs of disclosure counsels, the depository companies, and the debt advisory commission are paid by the financial and marketing specialist.

Bond Counsel

The treasurer's office used one attorney as its bond counsel for all its short-term debt. This one attorney worked for two law firms. Until late 1993, this attorney worked for the law firm of Buchalter, Nemer, Fields & Younger (Buchalter). In 1991, the board of supervisors authorized the treasurer to sign a sole-source contract with Buchalter to act as bond counsel for its debt issues. The former treasurer selected Buchalter because of the law firm's knowledge of operations of the county.

The treasurer's office used one attorney, who worked for two firms, for all its short-term debt.

The duties of the bond counsel include delivering an opinion on the legality of the debt issuance and other related matters. In rendering an opinion, the bond counsel reviews and examines applicable laws authorizing the issuance of securities, ascertains that all required procedural steps have been completed to ensure proper authorization and issuance of the securities, and determines that all federal tax law requirements governing the issuance of the debt have been met.

Buchalter acted as bond counsel on the three debt issues in 1993. The county paid $50,697 to Buchalter for two debt issues: the 1993 taxable notes and the 1993 tax and revenue anticipation notes. For the third debt issue, the $215 million Teeter Plan taxable notes, the county did not receive an invoice for legal services from Buchalter and therefore did not pay the firm for its legal services.

In December 1993, the attorney left Buchalter and joined the law firm of LeBoeuf, Lamb, Greene & MacRae (LeBoeuf). During that month, the treasurer's office issued a request for qualifications (RFQ) to various law firms to serve as bond counsel. After receiving seven responses from law firms, the county board of supervisors selected the law firm of LeBoeuf, based on the recommendation of the treasurer. The treasurer recommended this law firm because LeBoeuf received the highest score of the seven competing law firms. A deputy county counsel and the former assistant treasurer evaluated the seven responses and scored each firm based on experience, fees, and responsiveness to the RFQ.

As Table 5 shows, LeBoeuf was the bond counsel for all six debt issues in 1994 and earned $61,955. However, the county has not yet paid LeBoeuf $8,000 for the $111 million Teeter Plan taxable notes and the $8,000 for the $64 million Teeter Plan tax-exempt notes. In addition to the fees shown in Table 5, LeBoeuf earned $16,681 for general legal services related to debt issues.

Financial and Marketing Specialists

One financial advisor was involved in all nine short-term debt issues and was paid over $2 million from underwriters.

Financial and marketing specialists are consultants who provide advice regarding the structure, timing, terms, and other matters concerning a new debt issue. The treasurer's office used one firm on the 1993 short-term debt issues and two firms on the 1994 short-term debt issues. The firms are Leifer Capital, Inc. (Leifer) and Rauscher Pierce Refsnes, Inc. (Rauscher). Leifer was involved in all nine short-term debt issues and received 75 percent of underwriting fees paid by the treasurer's office.

According to county accounting records, Leifer did not receive any direct payments from the county for the short-term debt issues we reviewed. However, Leifer indicated that brokerage firms paid it $2,176,301 for financial advisory services from underwriting fees. According to Leifer, the firm assisted the county in negotiating the interest rates for the county's debt issues with the underwriters. Also, Leifer assisted the county in obtaining ratings for its debt issues from Standard & Poor's and Moody's Investor Services, reviewing financial documents, and evaluating alternative borrowing rate indices. From its fees, Leifer was responsible for paying the costs of the disclosure counsels, the depository companies, and the debt advisory commission. However, we do not know the amounts that Leifer paid to the other firms.

Treasurer's office cannot explain the selection of the financial advisor.

The treasurer's office cannot explain why Leifer was selected to be the financial and marketing specialist on all nine debt issues. The office also cannot tell us whether Leifer received its instructions from the treasurer's office, the underwriter, or both.

In addition, a second financial advisor, Rauscher, was involved in the six debt issues in 1994. The board of supervisors approved six contracts with Rauscher to act as a pricing consultant. On four of the six contracts, the board of supervisors selected Rauscher from a list of three firms submitted by the treasurer. In the remaining two contracts, we could not determine how Rauscher was selected. The duties of the firm included participating in pricing negotiations with the underwriters and providing information on economic conditions. For its pricing services on the six debt issues, Rauscher charged $10,000 for each and submitted an invoice for $60,000 to the county. However, the county had not yet paid Rauscher for its services as of February 1995.

The CAO Used a Variety of Selection Methods for Long-Term Debt

We reviewed 14 long-term debt issues at the CAO. These debt issues totaled approximately $1 billion in 1993 and 1994. Approximately $10.739 million was incurred for underwriter fees, bond counsel fees, and financial advisory fees.

The CAO used competitive bidding procedures to select an underwriter on two related debt issues: Orange County limited obligation improvement bonds for Newport Ridge, Series A of 1993 for $4.330 million and Series B of 1994 for $7.515 million. For the remaining 12 debt issues, the CAO recommended and the board of supervisors selected or appointed the underwriters. On all 14 debt issues, the CAO recommended and the board of supervisors selected or appointed the bond counsels and the financial advisors.

The CAO selected professional service firms from preapproved lists.

Generally, the underwriters, bond counsels, and financial advisors were selected from preapproved lists of qualified firms. When a selection process was used, the CAO compared the requirements for a debt issue with the current lists of qualified firms. Then the CAO either submitted the names of several qualified firms for each type of professional service to the board of supervisors or, in some cases, recommended only one firm from the list of qualified firms.

In 1989, the CAO established lists of qualified underwriters, bond counsels, and financial advisors. The 1989 lists consist of 21 underwriters, 12 bond counsels, and 3 financial advisors. In January 1989, the board of supervisors approved the lists of underwriters, bond counsels, and financial advisors that the CAO identified as qualified. The CAO was unable to provide documentation of the process used in 1989 to qualify the firms. The CAO has not established new lists of qualified underwriters and bond counsels since 1989.

The CAO established a new list of financial advisors in April 1994. The CAO requested 30 firms to submit their qualifications to be the financial advisor. After evaluating the qualifications from the 18 responding firms, the CAO selected 11 qualifying firms to be placed on the list of financial advisors. Then the CAO recommended the approval of the list of 11 qualified firms to the board of supervisors. In April 1994, the board adopted the CAO recommendation.

When a debt issue was unusual or specialized, the CAO established a special list for a specific debt. For example, in 1994, the CAO developed special lists of underwriters and bond counsels for the $320 million pension obligation debt.

As shown in Table 6 on the following pages, underwriters for long-term debt received $9.095 million. The county used both sole and joint underwriters for its long-term debt issues. For example, the CAO used PaineWebber, Inc. as the sole underwriter on two debt issues. PaineWebber, Inc. earned $831,623 as the underwriter for these long-term issues. Merrill Lynch earned $353,664 for three debt issues, and Stone & Youngberg earned $817,320 for two debt issues. The remaining seven debt issues used joint underwriters. We were unable to separate the amount paid to the individual firms on the debts jointly underwritten. The fees for joint underwriters totaled $7.093 million.

Eighteen firms earned $10.7 million for professional services on long-term debt.

The CAO used five different bond counsels for its long-term debt and paid $1,164,587 for legal services, as shown in Table 6. One firm, Stradling, Yocca, Carlson & Rauth, worked on eight debt issues and earned $773,143. This figure represents 66.4 percent of all bond counsel fees earned in 1993 and 1994.

Additionally, Table 6 shows that the CAO used five financial advisors for the long-term debt. In total, the financial advisors earned $479,468 for the 1993 and 1994 debt issues. Fieldman, Rolapp & Associates worked on five debt issues and earned $157,253, representing 32.8 percent of all financial advisory fees. CGMS Inc. earned $151,998 (31.7 percent) for four debt issues.

Brokerage Firms' Earnings Cannot Be Estimated

Because many of the fees, commissions, and other compensation or revenues earned by brokerage firms are not paid directly by the county, only limited information can be obtained from the treasurer's office. Therefore, to obtain this information, we mailed letters to brokerage firms that did business with the county. Specifically, we requested a listing **of all compensation related to investment activities** that each firm earned or received directly or indirectly from the county. We are aware that on many investment transactions, brokers earn revenues not directly from fees or commissions but from the difference between the purchase and sale prices. We do not believe that all firms provided us with the amount of revenue earned from these transactions.

Table 6

Costs for Underwriters, Bond Counsels, and Financial Advisors for Long-Term Debt Calendar Years 1993 and 1994

Description of the Debt	Underwriter Selected	Underwriter Fees[a]	Bond Counsel Selected	Bond Counsel Fees	Financial Advisor Selected	Financial Advisor Fees
1993 Debt Issues						
$24.78 million Certificates of Participation (Master Lease Program), Series A	PaineWebber, Inc.	$ 235,410	Stradling, Yocca, Carlson & Rauth	$ 51,390	California Financial Services	$ 66,906
$13.695 million Community Facilities District #87-5E of Orange County Special Tax Bonds (Rancho Santa Margarita), Series A	Stone & Youngberg and Donaldson, Lufkin & Jenrette Securities Corporation	267,053	Stradling, Yocca, Carlson & Rauth	56,036	CGMS Inc.	27,522
$30.575 million Community Facilities District #87-4 of Orange County Special Tax Bonds (Foothill Ranch), Series A	PaineWebber, Inc.	596,213	Stradling, Yocca, Carlson & Rauth	68,075	Fieldman, Rolapp & Associates	27,500
$4.33 million Orange County Limited Obligation Improvement Bonds Assessment District #92-1 (Newport Ridge), Series A	Merrill Lynch Capital Markets	45,726	Orrick, Herrington & Sutcliffe and Sturgis, Ness, Brunsell & Assaf	36,493 8,698	Fieldman, Rolapp & Associates	35,500
$79.755 million Orange County, California Airport Revenue Refunding Bonds, Series 1993	Merrill Lynch & Co. and Lehman Brothers	692,872	Brown & Wood	75,000	None used	Not applicable
$57.965 million Orange County Development Agency Santa Ana Heights Project Area Tax Allocation Revenue Bonds	Stone & Youngberg	663,120	Stradling, Yocca, Carlson & Rauth	87,965	Rosenow Spevacek Group Inc.	18,311
$10.114 million Orange County Limited Obligation Improvement Bonds Irvine Coast Assessment District #88-1, Series A	Merrill Lynch & Co.	185,820	Orrick, Herrington & Sutcliffe	30,328	Fieldman, Rolapp & Associates	15,000
$7.635 million Orange County, California Variable Rate Demand Apartment Development Revenue Refunding Bonds (Villa Marguerite Apartments), Issue A	PaineWebber, Inc. and Bancroft, Garcia & Lavell, Inc.	76,350	Stradling, Yocca, Carlson & Rauth	37,502	CGMS Inc.	36,989

(continued on next page)

Description of the Debt	Underwriter Selected	Underwriter Fees[a]	Bond Counsel Selected	Bond Counsel Fees	Financial Advisor Selected	Financial Advisor Fees
$2.67 million Orange County, California Variable Rate Demand Apartment Development Revenue Refunding Bonds (Trabuco Woods Apartments), Issue B	PaineWebber, Inc. and Bancroft, Garcia & Lavell, Inc.	33,375	Stradling, Yocca, Carlson & Rauth	22,175	CGMS Inc.	27,487
1994 Debt Issues						
$7.515 million Orange County Limited Obligation Improvement Bonds Assessment District #92-1 (Newport Ridge), Series B	Merrill Lynch Capital Markets	122,118	Orrick, Herrington & Sutcliffe	65,925	Fieldman, Rolapp & Associates	19,253
$219.325 million South Orange County Public Financing Authority Special Tax Revenue Bonds, Series A and B	Stone & Youngberg; Kidder, Peabody & Co., Inc.; and Merrill Lynch & Co.	1,901,280	Stradling, Yocca, Carlson & Rauth	225,000	CGMS Inc.	60,000
$15.42 million Orange County Reassessment District #94-1 Limited Obligation Refunding Bonds (Golden Lantern)	Stone & Youngberg	154,200	Orrick, Herrington & Sutcliffe	30,000	None used	Not applicable
$239.34 million South Orange County Public Financing Authority Special Tax Revenue Bonds (Foothill Area), Series C	PaineWebber, Inc. and Stone & Youngberg	1,795,000	Stradling, Yocca, Carlson & Rauth	225,000	Fieldman, Rolapp & Associates	60,000
$320.04 million Orange County, California Taxable Pension Obligation Bonds, Series A and B	CS First Boston; Kidder, Peabody & Co., Inc.; and Donaldson, Lufkin & Jenrette Securities Corporation	2,326,652	Jones, Day, Reavis & Pogue	145,000	O'Brien Partners Inc.	85,000
Total $1,033,159,000		**$9,095,189**		**$1,164,587**		**$479,468**

[a] For issues with more than one underwriter, the amount earned by each individual underwriter was not available.

We focused on 14 firms that had outstanding reverse repurchase agreements with the county before the bankruptcy filing on December 6, 1994. Eight of the 14 firms provided information on revenues that they earned from the county for 1994 and 1993. In total, the eight firms stated that they earned at least $21,331,656 in 1994 and $46,298,000 in 1993. Merrill Lynch reported receiving the most revenue from the county—$20.2 million in 1994 and $42.2 million in 1993.[2] Table 7 on the following page presents the amount of compensation for 1994 and 1993 that the firms reported to the Bureau of State Audits.

Six of the 14 firms did not respond to our letter or did not provide the compensation information requested. These firms are Bank of America, CS First Boston Corporation, Cantor Fitzgerald, Fuji Securities, Kidder Peabody, and Nomura Securities International, Inc.

The reader should exercise caution in interpreting brokers' reported revenues.

In evaluating the revenues presented in Table 7, the reader should exercise caution in interpreting the results. We do not believe that the firms reported all their compensation earned on the county's investment transactions. For example, most of the firms did not report revenues on reverse repurchase agreements. These agreements represented billions of dollars worth of transactions with the treasurer's office. At least three firms stated that they did not earn "commissions" on these types of transactions with the county. Smith Barney, Inc. reported that no commissions were charged for reverse repurchase transactions. Sanwa Securities (USA) Co., L.P. reported that it did not charge commissions for transactions on repurchase agreements or for the purchase or sale of securities. Acknowledging that compensation encompasses more than commissions, Donaldson, Lufkin & Jenrette, Inc. stated that although it had investment transactions with the county, there were no fees or commissions because it conducted transactions on a principal basis only at a competitive bid or offer price.

Fees Incurred for Expenses Related to the Bankruptcy

As of March 13, 1995, the county estimated that the expenses for the bankruptcy will be approximately $23.7 million for ten firms retained because of the bankruptcy. This estimate covers costs

[2] On March 7, 1995, the board of supervisors removed Merrill Lynch from the county's list of qualified underwriters.

Table 7

Revenue Reported by Brokerage Firms
Calendar Years 1994 and 1993

Name of Firm	Source of Revenue	1994	1993
Responding Firms			
Merrill Lynch, Pierce, Fenner & Smith, Inc.[a]	All services	$20,200,000	$42,200,000
Smith Barney Inc.	Brokerage and investment banking	434,033	1,351,106
Dean Witter Reynolds Inc.	Commissions	315,803	1,694,275
Prudential Securities Incorporated	Commissions	269,500	574,000
PaineWebber, Inc.	Underwriting[b]	42,250	386,910
Donaldson, Lufkin & Jenrette, Inc.	Underwriting	47,277	56,003
Morgan Stanley & Company Inc.	Commissions	22,793	35,706
Sanwa Securities (USA) Co., L.P.		0	0
Total		**$21,331,656**	**$46,298,000**

Firms Not Responding or Not Providing Requested Information

Bank of America

CS First Boston Corporation

Cantor Fitzgerald

Fuji Securities

Kidder Peabody

Nomura Securities International, Inc.

[a] The source of the information was a letter from a law firm representing Merrill Lynch, Pierce, Fenner & Smith, Inc., dated February 3, 1995, to the Senate Special Committee on Local Government Investments.

[b] PaineWebber, Inc. stated it could not readily determine information on investment transactions.

At least $23.7 million will be spent through June 30, 1995, on bankruptcy expenses.

through June 30, 1995. These firms consist of five law firms, four financial advisors, and one communication specialist. The duties of the firms include providing legal services for the bankruptcy, litigation services, and financial advisory services. The county selected nine of the ten firms on a sole-source basis. In December 1994 and January 1995, the board of supervisors approved the selection of nine of the ten firms. The communication specialist, Sitrick and Company, Inc., was not specifically approved by the board of supervisors.

The county has not yet estimated the costs beyond June 30, 1995. In addition, it is unknown how long some of these contracts will continue. Table 8 presents the names of the firms retained by the county and the type of services the firms provide. The table also provides the county's estimate of the costs for the firms through June 30, 1995, and the basis for compensating each of them. Finally, Table 8 reflects the amount of charges that the firms have submitted to the county and the periods covered by the charges as of March 13, 1995.

The services by five of the ten firms are complete. The five firms are Squire, Sanders & Dempsey; Hawkins, Delafield & Wood; Thomas W. Hayes; Peacock, Hislop, Staley, & Given; and Sitrick and Company, Inc.

In addition to the firms included in Table 8, the county intends to contract with other firms for professional services. For example, the board of supervisors authorized county staff to negotiate contracts with two underwriters (Goldman, Sachs & Co. and A.G. Edwards Sons, Inc.) and one repository service firm. Although the board of supervisors approved the hiring of the two underwriters, the county does not yet know the estimated cost for these two contracts. The county estimated that the cost of the repository service firm would be $75,000 through June 30, 1995.

Legal Fees for Certain Employees

The board of supervisors authorized the county to provide legal representation for the board of supervisors and certain current or former county employees. The county estimates that the cost of providing legal representation for these employees would be approximately $545,000 through June 30, 1995.
Section 995 of the California Government Code requires a public entity to provide for

Table 8

Bankruptcy and Financial Management Services by Law Firms, Financial Advisors, and One Other Consultant December 1994 Through June 1995

Name of Firm	Services to Be Performed	County's Estimate of Cost Through June 30, 1995	Invoices Received From Firm as of March 13, 1995	Period Covered by Invoice	Basis for Compensation[a]
<u>Law Firms</u>					
Stutman, Treister & Glatt	Legal counsel for the federal bankruptcy filing	$ 3,500,000	$ 315,187[b]	December 6, 1994 through December 31, 1994	Hourly rates from $150 to $435 for attorneys
Howrey & Simon	Legal counsel for litigation arising from the bankruptcy	4,000,000	467,076[b]	December 7, 1994 through December 31, 1994	Hourly rates from $178 to $395 for attorneys plus charges for experts and consultants
Willkie, Farr & Gallagher	Legal counsel on debt issues	1,675,000	152,836	December 20, 1994 through January 20, 1995	Hourly rates from $110 to $400 for attorneys
Squire, Sanders & Dempsey and Hawkins, Delafield & Wood	Legal counsel on debt administration	500,000	230,750[c] 266,086[c]	December 6, 1994 through January 31, 1995	Hourly rates from $115 to $360 for attorneys
<u>Financial Advisors</u>					
Thomas W. Hayes	Director of financial restructuring for the treasurer's office investment portfolio	50,000	25,821	December 9, 1994 through February 2, 1995	Biweekly payments of $5,379
Arthur Andersen LLP	Accounting, financial consulting, and other services related to the bankruptcy filing	4,400,000	389,801[b]	December 13, 1994 through December 31, 1994	Hourly rates for professional staff ranging from $75 to $350, minus a discount of 10 percent
Salomon Brothers Inc.	Financial advisory and investment banking services for the financial restructuring of the portfolio of investments, including liquidating securities	9,092,820[d]	8,342,820[d]	December 9, 1994 through December 31, 1994	Minimum charge of $1,400,000 includes an up-front payment of $500,000 plus a minimum of $150,000 each month for six months; also, fees and commissions for the management and sale of securities
Peacock, Hislop, Staley, & Given	Sale of securities from the investment pool	20,000[d]	20,000[d]	January 1995	Competitive bid
<u>Other Consultant</u>					
Sitrick and Company, Inc.	Public relations services	450,776	450,776[c]	December 6, 1994 through February 2, 1995	Hourly rates from $150 to $350 per hour for professional staff
	Total	**$23,688,596**	**$10,661,153**		

[a] Includes other related expenses.

[b] The board of supervisors authorized payments to three firms that were less than the amount submitted.

[c] The county is reviewing the propriety of the charges on the invoices.

[d] Includes costs to be shared by the county and the other participants in the investment portfolio.

the defense of any civil action or proceeding brought against the employee, in his or her official capacity or individual capacity, for an act of omission in the scope of his or her employment as a public entity employee. However, the Government Code permits a public entity to refuse to provide for the defense of the employee if the act or omission was not within the scope of employment or if the employee acted or failed to act because of actual fraud, corruption, or malice.

The county agreed to provide and pay for legal representation for the employees in connection with the U.S. Securities and Exchange Commission investigation and 11 class-action lawsuits. The five employees are Robert Citron, former county treasurer; Matthew Raabe, former assistant treasurer; Ernie Schneider, former chief administrative officer; Eileen Walsh, former director of finance; and Steven Lewis, county auditor-controller. On January 25, 1995, the county counsel notified former treasurer Citron and former assistant treasurer Raabe that the county would no longer provide legal representation. The effective date of the termination of legal representation was February 4, 1995. The county discontinued the legal representation because of possible accounting irregularities that would indicate that the employees' acts and/or omissions may have been beyond the scope of their employment and would suggest that the employees acted or failed to act because of actual fraud, corruption, or malice.

The county discontinued legal representation to two former officials because of possible accounting irregularities.

In addition, the board of supervisors authorized legal representation for employees of the auditor-controller and the treasurer's offices related to the investigation by the U.S. Securities and Exchange Commission.

Further, the county retained the law firm of Bryan Cave to provide legal representation for the board of supervisors. The legal representation is for potential civil lawsuits and for the investigation by the U.S. Securities and Exchange Commission.

Table 9 on the following page presents estimated costs for legal representation for current and former employees. The table also identifies the amount of charges that the firms have submitted to the county as of March 13, 1995. Finally, Table 9 presents the basis for compensating each of the law firms.

Table 9

Estimated Costs To Provide Legal Representation for Current and Former Employees December 1994 Through June 1995

Law Firm	Services to Be Performed	County's Estimate of Cost Through June 30, 1995	Invoices Received From Firm as of March 13, 1995[a]	Period Covered by Invoices	Basis for Compensation[b]
Bryan Cave	Legal counsel to the board of supervisors in the U.S. Securities and Exchange Commission investigation	$100,000	$28,996	December 6, 1994 through December 31, 1994	Hourly rates from $120 to $310 for attorneys
David Wiechert	Legal services for Robert Citron, former treasurer	100,000	67,096	December 1994 through January 1995	Hourly rate of $240 for attorney
Bird, Marella, Boxer, Wolpert, & Matz	Legal services for Matthew Raabe, former assistant treasurer	100,000	49,827	December 1994	Hourly rates of $275 to $300 for attorneys
Donahue, Mesereau & Wells	Legal services for Ernie Schneider, former chief administrative officer	60,000	10,294	January 1995	Hourly rate of $275 for attorney
Squire, Sanders & Dempsey	Legal services for Eileen Walsh, former director of finance	50,000	37,985	December 1994 through January 1995	Hourly rates of $100 to $310 for attorneys
Michaelson & Levine	Legal services for Eileen Walsh, former director of finance	50,000	No invoice received		Not available
Greenberg, Glusker, Fields, Claman & Machtinger	Legal services for Steven Lewis, auditor-controller	50,000	10,535	December 1994	Hourly rates of $125 to $375 for attorneys
Barton, Klugman & Oetting	Legal services for employees of the auditor-controller and treasurer's offices related to the investigation by the U.S. Securities and Exchange Commission	35,000	No invoice received		Hourly rates from $200 to $235 for attorneys
	Total	**$545,000**	**$204,733**		

[a] The county is reviewing the propriety of the charges on the invoices.

[b] Includes other related expenses.

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Chapter 4

Recommendations

During the course of our audit of Orange County's (county) investment practices, we reviewed and evaluated the circumstances that led to the loss of $1.69 billion and the county's bankruptcy. Therefore, we are making recommendations to the county that we believe appropriately address its current problems and provide solutions for the future.

This audit also provides a unique opportunity to reassess the laws that govern local government investing and to review the parameters of prudent investment policies. Because issues relating to local government investment practices have a statewide impact, we are also recommending that the Legislature amend state law to provide reasonable guidance, safeguards, and oversight to prevent similar events from occurring in the future.

We recommend that the Orange County board of supervisors direct the county treasurer to create a comprehensive investment policy that will:

- Establish guidelines to achieve safety, liquidity, and yield, in that order, including those related to diversifying the portfolio, preserving the capital, maintaining liquidity to meet cash flow and disbursement needs, and attaining a reasonable rate of return;

- Specify authority and accountability over investment practices by defining prudence and detailing fiduciary responsibilities, establish parameters for investments (e.g., time horizons and cash flow requirements), and set investment performance benchmarks and risk tolerances;

- Establish criteria for selecting brokers and dealers to ensure their financial viability and that they meet all professional standards;

- Establish a competitive bidding process to ensure that all investments are purchased competitively from brokers and dealers chosen from an authorized list;

- Create an investment advisory committee independent of the treasurer that is empowered to advise the board on the actions of the treasurer and the treasurer's compliance with the approved investment policy;

- Require the treasurer to report at least quarterly to the board, the advisory committee, and pool participants detailing investment activities and holdings, including market values, weighted average maturity, duration or other similar interest rate sensitivity analyses, and estimated yield. Further, the report must indicate the brokers and dealers used and the value of the business transacted with each of them;

- Ensure that reverse repurchase agreements are used in accordance with existing statutes. In no case should the use of reverse repurchase agreements or other types of borrowing exceed more than 5 percent of the portfolio. Further, multiple levels of borrowing should be prohibited; and

- Limit the use of derivatives or other structured investment instruments and prohibit those that put principal at risk. None of these instruments are to be purchased with borrowed or leveraged funds. Further, the derivatives or structured investments purchased should be openly traded in the secondary market on a recognized exchange. Any investments in these instruments should be limited to no more than 5 percent of the portfolio.

Finally, we recommend that the board of supervisors:

- Adopt and approve the county's comprehensive investment policies;

- Establish strict rules regarding ethics, conflict of interest, and asset safekeeping for all the county's investment activities;

- Ensure that the inequities caused by inappropriate interest allocations and the transfer of the county's losses to other pool participants are resolved and that all pool participants are treated equitably;

- Ensure that future allocations of investment earnings are accurate and establish safeguards over the allocation system; and

- Restore the $73 million in the Teeter Plan taxable note repayment fund that was inappropriately transferred to the county's general fund in December 1994.

The Legislature should amend the California Government Code related to local government investment practices to:

- Require written investment policies for all local entities investing public funds that are approved and adopted by their local governing

body. These policies should ensure that safety and liquidity are paramount to yield;

- Limit the use of reverse repurchase agreements to no more than 20 percent of the total portfolio, primarily to meet immediate or unexpected cash flow requirements, and not for reinvestment. In no case should the use of reverse repurchase agreements or other types of borrowing for yield enhancement or risk arbitrage exceed more than 5 percent of the portfolio. Further, multiple levels of borrowing should be prohibited;

- Establish and define a prudent person rule for the local investment officer. The prudent person rule should detail the fiduciary responsibilities vested in the investment officer and establish an expected level of expertise;

- Limit the use of derivatives or other structured investment instruments and prohibit those that put principal at risk. None of these instruments are to be purchased with borrowed or leveraged funds. Further, the derivatives or structured investments purchased should be openly traded in the secondary market on a recognized exchange. Any investments in these instruments should be limited to no more than 5 percent of the portfolio;

- Require that investment officers consider purchasing securities receiving a favorable volatility rating from a nationally recognized credit rating agency, whenever possible. These ratings provide important information about an investment by assessing risk over a wide range of conditions, including the effect of interest rates, prepayments, credit, spread, liquidity, and currency fluctuations;

- Impose limitations on the average length of maturity for local government investment portfolios to meet cash flow requirements and liabilities;

- Require competitive bidding or pricing for all investments purchased and mandate that the investment officer maintain a competitive selection history;

- Mandate investment reports at least quarterly to the governing body and investment pool participants that include detail of the inventory and transactions during the period, weighted average maturity, current market value, duration or other similar interest rate sensitivity analyses, and yield calculation of the portfolio; and

- Prohibit the issuance of taxable or nontaxable debt for the purpose of investing the proceeds in an investment pool or purchasing an investment security for speculation or risk arbitrage.

We conducted this review under the authority vested in the state auditor by Section 8543 et seq., of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope of this report.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Date: March 28, 1995

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Inappropriate Transfer of Restricted Funds

On February 2, 1995, the Bureau of State Audits issued a status report on Orange County's cash flow estimates (Report No. 94026.2). As part of that report, we questioned the transfer of $73 million from the Teeter Plan taxable note repayment fund into the county's general fund. To ensure the validity of our conclusions regarding this transfer, we sought an opinion from legal counsel on the issue. Based on our legal counsel's review, we have concluded that the $73 million transfer from the taxable note repayment fund to the general fund was improper.

In July and August 1994, the county borrowed $175 million by issuing Teeter Plan taxable notes for $111 million and Teeter Plan tax-exempt notes for $64 million. The board of supervisors' resolutions for the two debt issues required the county to secure the payment of principal and interest on the notes by a pledge of delinquent tax payments, including penalties and interest. Also, the resolutions required the county to deposit pledged monies into two restricted funds as security for the payment of principal and interest on the notes. The restricted funds are required to be designated as the taxable repayment account and the tax-exempt repayment account. Further, the resolutions required that until the notes and all interest had been paid or until provisions had been made for the payment of the notes at maturity with interest, any monies in the note repayment funds should be applied solely for the benefit of the owners of the notes.

The county violated the requirements to establish two funds. Instead, the county established only one fund: the Teeter Plan taxable note repayment (taxable note repayment) fund. During August 1994, the county

transferred approximately $73 million from its general fund to fulfill the pledge provisions into the taxable note repayment fund. Then in December 1994, subsequent to the bankruptcy, the county transferred approximately $73 million from the taxable note repayment fund back into the county general fund. County records revealed that the $73 million consisted of approximately $64 million for the Teeter tax delinquency transfer, approximately $6 million for prepaid interest on the taxable notes, and approximately $3 million for prepaid interest on the tax-exempt notes. The provisions of the Teeter Plan taxable notes require that any monies deposited into the taxable note repayment fund be used for the payment of principal and interest on the notes. Because the $73 million was deposited into the taxable note repayment account, it was restricted and was not available for the benefit of the county.